No. 87-1020-ASX
Status: GRANTED

Title: Paul S. Davis, Appellant
v.
Michigan Department of Treasury

Docketed:
December 21, 1987

Court: Court of Appeals of Michigan

Counsel for appellant: Davis,Paul S.

Counsel for appellee: Caruso,Louis J.

| Entry | Date | Note | Proceedings and Orders |
|---|---|---|---|
| 1 | Dec 21 1987 | G | Statement as to jurisdiction filed. |
| 3 | Jan 13 1988 | X | Motion of appellee Michigan Department of Treasury to dismiss or affirm filed. |
| 2 | Jan 20 1988 | | DISTRIBUTED. February 19, 1988 |
| 4 | Feb 22 1988 | P | The Solicitor General is invited to file a brief in this case expressing the views of the United States. |
| 5 | Jun 6 1988 | X | Brief amicus curiae of United States filed. |
| 6 | Jun 7 1988 | | REDISTRIBUTED. June 23, 1988 |
| 7 | Jun 27 1988 | | PROBABLE JURISDICTION NOTED. |
| | | | ****************************************************** |
| 8 | Jul 26 1988 | | Joint appendix filed. |
| 10 | Aug 1 1988 | | Order extending time to file brief of appellant on the merits until September 1, 1988. |
| 11 | Aug 29 1988 | | Brief of appellant Paul S. Davis filed. |
| 12 | Sep 1 1988 | | Brief amicus curiae of National Association of Retired Federal Employees filed. |
| 13 | Sep 1 1988 | | Brief amicus curiae of United States filed. |
| 14 | Sep 9 1988 | G | Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed. |
| 16 | Sep 14 1988 | | Order extending time to file brief of appellee on the merits until October 19, 1988. |
| 17 | Oct 3 1988 | | Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED. |
| 18 | Oct 19 1988 | | Brief of appellee Michigan Department of Treasury filed. |
| 19 | Oct 24 1988 | | SET FOR ARGUMENT. Monday, January 9, 1989. (4th case) (1 hr.) |
| 20 | Oct 24 1988 | | CIRCULATED. |
| 21 | Nov 7 1988 | X | Reply brief of appellant Paul S. Davis filed. |
| 22 | Jan 9 1989 | | ARGUED. |

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EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

87 1020 (1)



NO. ________

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

PAUL S. DAVIS,

Appellant

v.

STATE OF MICHIGAN,
DEPARTMENT OF THE TREASURY,

Appellee

ON APPEAL FROM THE
COURT OF APPEALS OF MICHIGAN

# JURISDICTIONAL STATEMENT

PAUL S. DAVIS
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39 pp

## QUESTION PRESENTED

Whether Section 30(1)(h) of the Michigan Income Tax Act [MCLA 206.30(1)(h); MSA 7.557(130)(1)(h)],which completely exempts from Michigan income tax retirement benefits paid to retirees of the State and its political subdivisions, but gives no equivalent exemption to retirement benefits paid to retirees of the Federal Government, is invalid, as applied to Federal retirees, as being in violation of the Federal statute (4 U.S.C. 111), which permits State taxation of compensation of Federal employees only if the taxation does not discriminate against the employee because of the source of the compensation.

## PARTIES

The names of all parties to the proceeding are set forth in the caption.

## TABLE OF CONTENTS

APPENDIX (continued)



## TABLE OF AUTHORITIES

CASES:

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

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PAUL S. DAVIS, Appellant

v.

STATE OF MICHIGAN, DEPARTMENT OF THE TREASURY, Appellee

---

ON APPEAL FROM THE COURT OF APPEALS OF MICHIGAN

---

## JURISDICTIONAL STATEMENT

Paul S. Davis, Appellant herein, a member of the Bar of this Court, appearing *pro se*, appeals to this Court from the final judgment of the Court of Appeals of Michigan, dated May 5, 1987.

## OPINIONS BELOW

*Davis v. Department of Treasury*, 160 Mich. App. 98, 408 N.W. 2d 433 (May 5, 1987) (set forth in Appendix A).

Oral Opinion of the Michigan Court of Claims, not reported (set forth in Appendix C).

GROUND FOR JURISDICTION

Appellant initiated this case by filing in the Michigan Court of Claims his Complaint for Refund of Income Taxes. In his Complaint Appellant sought a refund of Michigan income taxes paid on his Federal retirement benefits. Appellant specifically alleged that such taxation was invalid under the Federal statute (4 U.S.C. 111), and sought a judgment that the Michigan Income Tax Act, in so far as it purported to tax Federal retirement benefits, was invalid under Federal law. The Court of Claims and the Court of Appeals of Michigan upheld the validity of the Michigan Income Tax Act as applied to Appellant and ruled for the Defendant (here Appellee) Department of the Treasury, State of Michigan.

Appellant filed with the Supreme Court of Michigan an Application for Leave to Appeal from the Judgment of the Court of Appeals. Such leave to appeal was denied by order of the Michigan Supreme Court on September 28, 1987 (Appendix B).

Appellant filed a Notice of Appeal to this Court with the Court of Appeals of Michigan on December 4, 1987 (Appendix E). Copies of the Notice of Appeal were filed on the same day with the Michigan Supreme Court and with the Michigan Court of Claims.

Appellant invokes the jurisdiction of this Court pursuant to 28 U.S.C. 1257(2). The issue of the repugnancy of the Michigan Income Tax Act, as applied to Federal retirees, was properly raised at each level of State court proceedings and was expressly considered and decided by the Michigan Court of Appeals, the highest State Court exercising jurisdiction in this proceeding. This Court therefore has appellate jurisdiction.

## STATUTES INVOLVED

Michigan Income Tax Act, Section 30(l)(h) [1967 Public Act No. 281; M.C.L.A. 206.30 (l)(h); M.S.A. 7.557(130)(l)(h)].

4 U.S.C. 111 (Section 4 of Act of April 12, 1939, codified on September 6, 1966; 80 Stat. 808).

Federal Civil Service Retirement Act (5 U.S.C. 8331 *et seq.*), Section 8339(a).

The foregoing statutory provisions are set forth in Appendix F.

## STATEMENT OF THE CASE

Appellant is a former employee of the United States Government, and served as such from 1938 to 1942, from 1946 to 1956, and from 1974 to 1980. Based on his Government service, Appellant receives Federal Civil Service Retirement benefits, authorized pursuant to the Federal Civil Service Retirement Act (Act of July 31, 1956, as amended; 5 U. S. C. 8331 *et seq.*).

In filing his Michigan Income Tax returns for each of the tax years 1979 to 1984, inclusive, Appellant followed the instructions accompanying the forms prescribed by the Michigan Department of the Treasury, Appellee herein, and included all of his Federal retirement benefits in his taxable income. Subsequently Appellant filed amended tax returns for each of those years, in which he excluded his Federal retirement benefits from taxable income. In the amended returns and accompanying petitions and claims to the Michigan Revenue Commissioner Appellant petitioned for refunds of his Michigan income tax paid for those years, in so far as based on his Federal retirement benefits. The Revenue Commissioner denied Appellant's claims for refund. The amounts of such claims for refund for the years 1979 to 1984 aggregated $4,299.53.

Following denial of his claims for refund, Appellant filed in the Michigan

Court of Claims a Complaint seeking recovery of the Michigan income taxes paid on his Federal retirement benefits. In his claims for refund filed with the Revenue Commissioner and in the Court of Claims Appellant relied on the Federal statute, 4 U.S.C. 111, and took the position that the Michigan Income Tax Act, by completely exempting Michigan retirement benefits while taxing Federal retirement benefits, was invalid as being inconsistent with the Federal statute.

In the Court of Claims the case was heard on motions for summary disposition, since there was no dispute on the facts. After the filing of briefs and argument, the Judge of the Court of Claims rendered an oral Opinion, on October 30, 1985, in favor of the Appellee (Appendix C). The Michigan Court of Appeals affirmed the Court of Claims (Appendix A).

## THE QUESTION PRESENTED IS SUBSTANTIAL

The question of the validity of the Michigan Income Tax Act, in its application to Federal retirement benefits, depends on the interpretation of 4 U.S.C. 111. That Federal statute permits the non-discriminatory taxation by States of Federal compensation, and is as follows:

> "The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation." (Underscoring added).

### Federal Retirement Benefits Are Within the Scope of 4 U.S.C. 111

Appellant's Civil Service Retirement benefits are paid pursuant to the Civil Service Retirement Act (Act of July 31, 1956, as amended; 5 U.S.C. 8331 *et seq.*).

The amount of Appellant's retirement benefit is computed under the provisions of 5 U.S.C. 8339(a), and is based on salary and years of service (see Appendix F). As stated by the Court of Appeals for the Sixth Circuit in Hogan v. United States, 513 F. 2d 170, 172 (1975), "the amount of the annuity payable on retirement is "directly related to the earnings and years of service of the individual employee." (Underscoring added).

Appellee argued in the Michigan courts that since Appellant is no longer an officer or employee of the Federal Government the provisions of 4 U.S.C. 111 do not apply to him. The Court of Claims and the Court of Appeals accepted that argument. It is submitted that such an interpretation is incorrect, since the scope of the statute is not limited to current Federal rmployees.

The consent expressed in 4 U.S.C.

111 is not phrased in terms of the pay or compensation _of_ a present officer or employee. On the contrary, it expressly covers the "pay or _compensation_ for _personal_ _services_ _as_ an officer or employee of the United States." (Underscoring added). Appellant's retirement annuity is clearly a part of his compensation for his past Government work as an employee of the United States.

The word "compensation" is a broad concept, and is not limited to current salary. In _Clark_ _v_. _United_ States, 691 F. 2d 837 (1982), the Court of Appeals for the Seventh Circuit reviewed the history and purposes of the Federal Retirement law. The Court stated that the purpose of this statute "is to allow the federal government to compete with the private sector by offering

federal employees an attractive retirement plan." (691 F. 2d at page 842). The Court's opinion went on to refer to the retirement system as "a _deferred_ _compensation_ plan," designed to encourage employees to enter and remain in Government service (page 842; underscoring added).

Similarly, in _Kizas_ _v_. _Webster_, 707 F. 2d 524, 536 (D.C. Circuit, 1983), the Court referred to retirement benefits as being one incident of employee compensation. Again, in the recent decision of the Court of Appeals for the Federal Circuit in _Zucker_ _v_. _United_ _States_, 758 F. 2d 637, 639 (1985), cert. den. 474 U.S. 842, 106 S.Ct. 129, 88 L.Ed 2d 105 (1985), the Court referred to the legislative history of the Retirement Act, during which the pension benefits were characterized as "deferred wages."

The foregoing authorities demonstrate that Federal Retirement benefits constitute additional compensation for

past services to the Government. Accordingly they are clearly within the scope of the language of 4 U.S.C. 111, covering "compensation for personal service as an officer or employee of the United States," even though not actually paid until after retirement.

<u>The Michigan Income Tax Act Discriminates Against Federal Retirees, in Violation of 4 U.S.C. 111.</u>

The Michigan Income Tax Act discriminates against Federal retirees because of the <u>source</u> of their compensation, in violation of the express language of 4 U.S.C. 111. The Michigan Act taxes Federal retirement benefits, subject only to a limited exemption set forth in subparagraph (iv) of Section 30(1)(h) of that Act. On the other hand, the Michigan Act expressly exempts the <u>full</u> amount of retirement benefits received from a public retirement system of the State or any of its political subdivisions (subparagraph (i) of Section

30(1)(h)). Clearly this constitutes a discrimination against Federal retirees based on the source of their compensation.

In the recent case of Memphis Bank & Trust Company v. Garner, 459 U.S. 392, 103 S.Ct. 692, 74 L.Ed. 2d 562 (1983), this Court held invalid a Tennessee statute taxing bank earnings, which was defined to include interest on United States obligations but did not include interest on State obligations. The Court held that this statute discriminated "in favor of securities issued by Tennessee and its political subdivisions and against federal obligations," and that this constituted an unconstitutional discrimination. The Court concluded that "the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals." (459 U.S. at 399).

The Michigan Court of Appeals in its Opinion in this case discussed the

distinction in the law "between State retirees and all other retirees," and treated it in terms of the equal protection clause. The Court found a "legitimate state objective" (Appendix A, page A7). Appellant does not question the right of the State to favor its own retirees as against non-Federal retirees. But Appellant submits that the Federal law (4 U.S.C. 111) forbids discrimination against Federal retirees.

Two other decisions of this Court may be cited which emphasize that a State may not discriminate against Federal activities. Phillips Chemical Company v. Dumas Independent School District, 361 U.S. 376, 80 S.Ct. 474, 4 L.Ed.2d 384 (1960), cited in the Memphis case, supra, invalidated a tax which was imposed on lessees of property owned by the Federal Government, but which exempted lessees of property

owned by the State and its political subdivisions. The Court considered this to be a "substantial and transparent" discrimination against the Government and its lessees (361 U.S. at page 387).

Similarly, in Moses Lake Homes v. Grant County, 365 U.S. 744, 81 S.Ct. 870, 6 L.Ed.2d 66 (1961), this Court invalidated a tax on lessees of Federal property, where their leaseholds were assessed at the full value of the land and improvements, but other leaseholds were assessed only at their fair market value excluding the value of the improvements.

The case before this Court shows the same type of discrimination against Federal retirees as compared with retirees of State and local Michigan governments. Application of the Michigan Income Tax Act to the retirement benefits of Federal retirees is therefore clearly invalid under the decisions of this Court.

An Important Federal Question Is Presented

The question in this case involves the interpretation of an important Federal statute. Although this case concerns the validity of the Michigan tax law in its application to Federal retirees in Michigan, the interpretation of 4 U.S.C. 111 may also affect Federal retirees in other States.

For example, the State of Georgia has an income tax law similar to Michigan's in exempting State retirees while taxing Federal retirees [Code of Georgia Annotated, Section 91A-3607(a)(4)(A)]. In Waldron v. Collins, 788 F.2d 736 (1986), cert. den. ___ U.S. ___, 107 S.Ct. 274, 93 L.Ed.2d 250 (1986), the Court of Appeals for the Eleventh Circuit considered a case brought in a Federal District Court in Georgia by Federal retirees claiming discrimination. The Court of Appeals held that the plaintiffs had an adequate remedy in the State courts and

should have proceeded there. Accordingly the Court in the Waldron case did not reach the substantive question of the validity of the Georgia statute.

The State of Virginia also has a provision in its income tax law, similar to those of Michigan and Georgia, exempting its own retirees but taxing Federal retirement benefits [Code of Virginia, Title 58, Article 1, Section 322 C (3)]. On the other hand, Alabama and Kansas under their income tax laws exempt both their own and Federal retirees [Code of Alabama, Section 40-18-19(a)(1),(2)and (4); Kansas Statutes Annotated, Chapter 79, Section 32-117(c)(ii)and (vii)].

The existence of other State laws which may involve the interpretation of 4 U.S.C. 111 emphasizes the importance of the legal issues in this proceeding.

---

On the basis of the foregoing, it is submitted that the legal question

presented in this case is substantial. It involves an important matter of the interpretation of a Federal statute which should be resolved by this Court.

RELIEF REQUESTED

Appellant prays that this Court note its probable jurisdiction over this appeal, and that plenary consideration be given to this case with opportunity for the filing of briefs and oral argument.

Respectfully submitted,

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December 21, 1987

APPENDIX A

OPINION OF THE MICHIGAN

COURT OF APPEALS

(Reported in Davis v. Department of the Treasury, 160 Mich. App. 98, 408 N.W. 2d 433.)

| | |
|---|---|
| PAUL S. DAVIS, Plaintiff-Appellant | May 5, 1987 |
| v. | No. 88776 |
| STATE OF MICHIGAN, DEPARTMENT OF TREASURY Defendant-Appellee | |

Paul S. Davis, in propria persona.

*Frank J. Kelley*, Attorney General, *Louis J. Caruso*, Solicitor General, and *Richard R. Roesch* and *Robert C. Ward, Jr.*, Assistant Attorneys General, for defendant.

Before: D. E. HOLBROOK, JR., P.J., and WAHLS and G. W. CROCKETT, III,* JJ.

G. W. CROCKETT, III, J. Plaintiff appeals as of right from the order of the Court of Claims granting summary disposition to the Michigan Department of Treasury pursuant to MCR 2.116(I)(2) .

* Recorder's Court judge, sitting on the Court of Appeals by assignment.

The court upheld the department's decision to deny plaintiff an income tax refund in the amount of $4,299.53, for the tax years 1979 through 1984, finding that the taxation of plaintiff's federal retirement benefits was lawful.

The facts necessary for the resolution of this appeal are undisputed. Plaintiff is a resident of Michigan and retired federal government employee who receives federal civil service retirement benefits pursuant to 5 USC 8331 *et seq.* The issue on appeal is whether the Michigan Department of Treasury has the authority to impose an income tax on plaintiff's federal retirement benefits. Under the Michigan Income Tax Act, MCL 206.1 *et seq.*; MSA 7.557(101) *et seq.*, plaintiff was permitted to deduct from his taxable Michigan income no more than $7,500 of the amount he received in federal retirement benefits. MCL 206.30; MSA 7.557(130). By comparison, the same statutory provision permits state retirees receiving benefits from a public retirement system of the state or its political subdivisions to deduct retirement benefits in full. It is this differing tax treatment of retirement benefits which forms the basis of plaintiff's refund claims.

In 1984, plaintiff filed amended income tax returns for the tax years 1979 through 1982, claiming that he was entitled to a refund because his federal retirement benefits were allegedly not subject to income taxation by the State of Michigan. Plaintiff's refund requests were denied and he filed a complaint in the Court of Claims. Refund requests for tax years 1983 and 1984 were later added to the complaint by consent. Plaintiff asserted that the state tax was discriminatory as to source and therefore unlawful under federal law. The Court of Claims rejected plaintiff's arguments

and granted summary disposition to the department.

The department's authority to impose a tax on retirement benefits under Michigan law is provided for in MCL 206.30; MSA 7.557(130). As amended in 1984, the statute provides in relevant part:

> (h) Deduct to the extent included in adjusted gross income:
>
> (i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.
>
> (ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.
>
> (iii) Social security benefits as defined in section 86 of the internal revenue code.
>
> (iv) Retirement or pension benefits from any other retirement or pension system as follows:
>
> (A) For a single return, the sum of not more than $7,500.00.
>
> (B) For a joint return, the sum of not more than $10,000.00.

The State Employees' Retirement Act, MCL 38.1 *et seq.*; MSA 3.981(1) *et seq.*, which predates the MITA, also exempts from taxation the right of a person to a pension or retirement allowance accruing pursuant to the act. Further, the Michigan Constitution provides that the accrued financial benefits of each pension plan and retirement system of this state and its political subdivisions are declared to be contractual obligations thereof

which cannot be diminished or impaired. Const 1963, art 9, § 24. Michigan law does not extend similar status to federal pensions.

Initially, plaintiff argues on appeal that the Federal Public Salary Act of 1939 as amended, 4 USC 111, prohibits the discriminatory tax treatment of federal pensions which allegedly is present in the MITA. That federal statute provides:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, *if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.* [Emphasis added.]

The Court of Claims in this case determined that plaintiff was not an employee within the meaning of the above statute and therefore was not entitled to its protection. Plaintiff contends on appeal that the statute embraces both present and former employees. We agree with the Court of Claims.

By enacting 4 USC 111, Congress intended that federal employees should contribute to the support of their state and local governments, which confer upon them the same privileges and benefits which are accorded to persons engaged in private occupations. *United States v City of Pittsburgh,* 757 F2d 43 (CA 3, 1985). However, § 111 limits its coverage to federal officers or employees. The term employee has been defined as embracing only those who work for another for hire. *Allied Chemical & Alkali Workers of America v Pittsburgh Plate Glass Co.* 404 US 157: 92 S Ct 383: 30 L Ed 2d 341

(1971). Further, it has been held that a retired federal civil service employee is not to be considered an employee for civil service purposes. See *Lancellotti v Office of Personnel Management*, 704 F2d 91 (CA 3, 1983).

In this case, plaintiff's status as a retired federal employee is clearly not one who works for hire. Under the federal civil service retirement act, 5 USC 8331 *et seq.*, which governs plaintiff's retirement benefits, plaintiff is an annuitant. An annuitant is defined in 5 USC 8331(9) as a *former* employee who meets all the requirements to receive an annuity. Further, unlike the treatment of pension rights under the Michigan retirement system, a federal worker's pension rights are not treated as contractual obligations. Rather, their entitlement to retirement benefits must be determined from the statute and regulations which govern them, in this case 5 USC 8331 *et seq.*; *Zucker v United States*, 758 F2d 637 (CA Fed, 1985), cert den — US —; 106 S Ct 129; 88 L Ed 2d 105 (1985).

However, plaintiff contends that he should be treated as an employee for purposes of 4 USC 111, despite his retirement status, because his retirement benefits constitute a form of deferred compensation. While the legislative history of the federal civil service retirement act lends some support to plaintiff's argument, we are still unpersuaded. The federal civil service retirement plan was enacted with the purpose of establishing a deferred compensation plan to allow the federal government to compete with the private sector by offering an attractive retirement plan to federal employees. *Clark v United States*, 691 F2d 837, 842 (CA 7, 1982). Both the employee and the government contribute to the retirement fund. The eventual annuity that the retired employee re-

ceives is directly related to his earnings and years of service. See *Hogan v United States*, 513 F2d 170 (CA 6, 1975), cert den 423 US 836; 96 S Ct 62; 46 L Ed 2d 55 (1975). However, by statute, an annuitant is not considered an employee at the time he receives his annuity payments. Additionally, plaintiff has failed to show any express legislative intent or case authority to give a broad construction to the term employee as contained in 4 USC 111 to encompass retired employees. Indeed, we believe that had Congress so intended it would have clearly so provided. Therefore, we conclude, as did the Court of Claims, that 4 USC 111 has no application to plaintiff, since plaintiff cannot be considered an employee within the meaning of that act. Accordingly, the taxation of plaintiff's retirement benefits was not a violation of 4 USC 111.

Plaintiff also argues that under general federal case law, the imposition of a Michigan income tax on his federal retirement benefits is unlawful because it discriminates by source and burdens federal government activities. We cannot agree.

It is generally recognized that a tax may be held invalid, even if the tax burden does not fall directly on the United States, if it operates to discriminate against the federal government and those with whom it deals. See *Memphis Bank & Trust Co v Garner*, 459 US 392; 103 S Ct 692; 74 L Ed 2d 562 (1983). In determining the legality of statutory classifications which make a distinction between federal and nonfederal pensioners, an equal protection analysis has been applied. See *Clark v United States, supra*. The equal protection clause requires like treatment for persons similarly situated. However, a statute will be upheld against an equal protection attack if the distinctions bear a rational relationship to a legitimate

state end. See *In re Contempt of Stone*, 154 Mich App 121; 397 NW2d 244 (1986). In this case, as the party challenging the classification, plaintiff has the burden of showing that the classification is without any reasonable justification. *Halstead v City of Flint*, 127 Mich App 148; 338 NW2d 903 (1983), lv den 418 Mich 915 (1984). We do not believe that plaintiff has satisfied his burden in this case.

Under the Michigan income tax system, a class distinction is made between state retirees and all other retirees, including federal retirees. In our opinion, the attracting and retaining of qualified employees is a legitimate state objective which is rationally achieved by a retirement plan offering economic inducements. One such inducement to state employees is tax exempt status for their retirement benefits. The State of Michigan, as an employer, owes a special responsibility to its employees, which it does not owe to federal employees. The full tax exemption permitted by the MITA is simply intended to recognize that income tax exemption is an integral part of the retirement benefits conferred upon state employees. There is no indication that the MITA is aimed at discriminating against retirees by the source of their retirement benefits. Consequently, even if state and federal retirees are similarly situated, the state objective, as evidenced from the statutory scheme, is rational.

We also find that plaintiff's reliance on *Memphis Bank & Trust Co v Garner, supra*, is misplaced. In that case, the Supreme Court held invalid a Tennessee statute taxing bank earnings, which was defined to include interest on United States obligations but did not include interest on state obligations. However, in that case the Court was interpreting a federal statute which provided for a

broad exemption of federal obligations from state and local taxation. 31 USC 742. In this case, plaintiff can point to no statutory authority which prohibits the State of Michigan from taxing his retirement benefits.

Accordingly, we hold that the Court of Claims did not err in granting summary disposition to defendant and denying plaintiff's claim for an income tax refund.

Affirmed.

APPENDIX B

AT A SESSION OF THE SUPREME COURT OF THE STATE OF MICHIGAN, Held at the Supreme Court Room, in the City of Lansing, on the 28th day of September, in the year of our Lord one thousand nine hundred and eighty-seven.

Present the Honorable DOROTHY COMSTOCK RILEY, Chief Justice; CHARLES L. LEVIN, JAMES H. BRICKLEY, MICHAEL F. CAVANAGH, PATRICIA J. BOYLE, DENNIS W. ARCHER, ROBERT P. GRIFFIN, Associate Justices

PAUL S. DAVIS,

Plaintiff-Appellant

v.

STATE OF MICHIGAN, DEPARTMENT OF TREASURY,

Defendant-Appellee

SC: 80836

COA: 88776

LC: 84-9451

On order of the Court, the application for leave to appeal is considered, and it is hereby DENIED, because we are not persuaded that the questions presented should be reviewed by this Court.

Certified on September 28, 1987, by;

/s/ CORBIN R. DAVIS, Clerk of the Supreme Court

ORAL OPINION OF COURT OF CLAIMS

PAUL S. DAVIS, Plaintiff

v.

STATE OF MICHIGAN, DEPARTMENT OF THE TREASURY, Defendant

FILE NO. 84-9451

Before the Honorable JAMES R. GIDDINGS, JUDGE

October 30, 1985

THE COURT: Well, it seems to me a pretty clear reading of the Act. I guess I'm not sure that it would be discriminatory anyway in terms of the source; but assuming that's the case, I don't believe Section 111 of Title 4 applies by its terms. This talks about compensation for personal services; for personal services as an officer or employee of the United States, and the Lancelotti Third Circuit case, 1983 says they're not an employee. And, I think presumably if they intended to cover the retired employees, that would have said so.

And, it's my -- I'm concluding from the cases cited by Mr. Davis, Plaintiff, that Hogan and Clark did not hold that they were employees. They talked about some other policy language which I do not disagree with; it couldn't really directly pertain here and Memphis Bank does not apply.

I mean this is not an obligation to the United States, this is -- I mean it's an obligation in a sense, but not in the sense talked about by Memphis -- by the Memphis case and -- So, that one just does not apply.

Under the circumstances, as far as I can see, the tax imposed by the Department of Treasury is proper and the Court will deny the Motion for Summary Disposition and grant Summary Disposition in favor of Department of Treasury.

MR. WARD: Thank you, your Honor. I'll prepare the Order.

THE COURT: That's all on the record in that matter.

STATE OF MICHIGAN

IN THE COURT OF CLAIMS

PAUL S. DAVIS,

Plaintiff,

v NO. 84 9451

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY

Defendant.

_______________________/

ORDER GRANTING SUMMARY DISPOSITION

At a session of the Court, held in the Ingham County Circuit Courtroom, City Hall, City of Lansing, Michigan on the 7th day of November, 1985.

PRESENT: Honorable JAMES R. GIDDINGS,
Circuit Court Judge, Presiding

The Plaintiff having filed a Motion for Summary Disposition under MCR 2.116(C)(10) and the Defendant having requested Summary Disposition under MCR 2.116(I)(2), the Court having considered the pleadings filed by the parties including the amended pleadings, the Court having considered the oral argument of the parties and the written

briefs filed by the parties, and the Court having rendered its oral Opinion from the bench on Wednesday, October 30, 1985, affirming the decision of the Revenue Commissioner denying the Plaintiff's request for refund for tax years 1979 through 1984.

IT IS HEREBY ORDERED AND ADJUDGED that in accordance with the Court's oral Opinion of October 30, 1985, Plaintiff's Motion for Summary Disposition is DENIED and Defendant's Motion for Summary Disposition is GRANTED.

IT IS FURTHER ORDERED AND ADJUDGED that no costs be allowed to either party.

/s/ JAMES R. GIDDINGS

Honorable James R. Giddings
Circuit Court Judge

APPENDIX E

RECEIVED

DEC 4 1 09 PM '87

COURT OF APPEALS
SECOND DISTRICT
R L. DZIERBICKI, CLERK

STATE OF MICHIGAN

IN THE COURT OF APPEALS

| | | |
|---|---|---|
| PAUL S. DAVIS, | ) | |
| Plaintiff-Appellant | ) | DOCKET No. 88776 |
| v. | ) | (Michigan Supreme Court No. 80836) |
| STATE OF MICHIGAN, DEPARTMENT OF THE TREASURY, | ) | (Court of Claims No. 84-9451) |
| Defendant-Appellee | ) | |

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

NOTICE IS HEREBY GIVEN that Paul S. Davis, Plaintiff-Appellant herein, appearing pro se, hereby appeals to the Supreme Court of the United States from the final judgment of the Court of Appeals of the State of Michigan, entered on May 5, 1987.

This appeal is taken pursuant to 28 U.S.C. 1257(2).

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## PROOF OF SERVICE

The undersigned, Paul S. Davis, Attorney for Plaintiff-Appellant, *pro se*, hereby certifies that he served a copy of the foregoing Notice of Appeal to the Supreme Court of the United States, in the case of Paul S. Davis v. State of Michigan, Department of the Treasury, on Ross H. Bishop, Esq., Assistant Attorney General, Attorney for Defendant-Appellee herein, on this 4th day of December, 1987, by delivering a copy thereof to his office.

Paul S. Davis (P-12562)
Attorney for Plaintiff-
Appellant, *pro se*

Receipt is acknowledged of a copy of the foregoing Notice of Appeal to the Supreme Court of the United States, this 4th day of December, 1987.

Jill Zakrajsek, Secretary to
Ross H. Bishop
Assistant Attorney General
Attorney for Defendant-
Appellee

Rec'd at Court of Claims on 12-4-87 at 2:01 P.M. md

## STATUTORY PROVISIONS

Michigan Income Tax Act, Section 30 (1967 Public Act No. 281; M.C.L.A. 206.30; M.S.A. 7.557(130).

**§ 7.557(130) Taxable income of persons.]** Sec. 30. (1) "Taxable income" in the case of a person other than a corporation, an estate, or trust means adjusted gross income as defined in the internal revenue code subject to the following adjustments:

* * * * *

(h) Deduct to the extent included in adjusted gross income:

(i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.

(ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.

(iii) [Social security benefits as defined in section 86 of the internal revenue code.

(iv)] Retirement or pension benefits from any other retirement or pension system as follows:

(A) For a single return, the sum of not more than $7,500.00.

(B) For a joint return, the sum of not more than $10,000.00.

4 U.S.C. 111 (Section 4 of Act of April 12, 1939, codified on September 6, 1966; 80 Stat. 808).

**§ 111. Same; taxation affecting Federal employees; income tax**

The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

Federal Civil Service Retirement Act (5 U.S.C. 8339(a).

**§ 8339. Computation of annuity**

(a) Except as otherwise provided by this section, the annuity of an employee retiring under this subchapter is—

(1) 1½ percent of his average pay multiplied by so much of his total service as does not exceed 5 years; plus

(2) 1¾ percent of his average pay multiplied by so much of his total service as exceeds 5 years but does not exceed 10 years; plus

(3) 2 percent of his average pay multiplied by so much of his total service as exceeds 10 years.

However, when it results in a larger annuity, 1 percent of his average pay plus $25 is substituted for the percentage specified by paragraph (1), (2), or (3) of this subsection, or any combination thereof.

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1987

No. 87-1020

---

PAUL S. DAVIS,

Appellant,

v

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,

Appellee.

---

ON APPEAL FROM THE
SUPREME COURT OF THE STATE OF MICHIGAN

MOTION TO DISMISS OR AFFIRM

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## QUESTION PRESENTED

MAY THE STATE OF MICHIGAN EXEMPT RETIREMENT BENEFITS FROM STATE INCOME TAX WHICH IT OR ITS POLITICAL SUBDIVISIONS PAY TO THEIR RETIREES, WHILE STILL IMPOSING THE INCOME TAX ON ALL OTHER RETIREMENT BENEFITS IN EXCESS OF $7,500?

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1987

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PAUL S. DAVIS,

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v

STATE OF MICHIGAN,
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Appellee.

ON APPEAL FROM THE
SUPREME COURT OF THE STATE OF MICHIGAN

MOTION TO DISMISS OR AFFIRM

Pursuant to United States Supreme Court Rule 16, Appellee moves that Appellant's appeal from the Opinion of the Michigan Court of Appeals (JS A1-A6)[1] and from an

[1] Unless otherwise indicated, numbers in paranthesis preceded by "JS" will refer to pages of Appellant's Jurisdictional Statement.



Order of the Michigan Supreme Court denying leave to appeal, entered September 28, 1987 (JS A9), be dismissed on the following grounds:

1. That the appeal does not present a substantial federal question; and

2. That the Opinion of the Michigan Court of Appeals is conclusive.

In the alternative, Appellees move that the opinion be affirmed on the grounds that it is manifest that the question on which the decision of this cause depends is so insubstantial as to need no further argument.

STATEMENT OF THE CASE

The sole issue presented by this case is succinctly stated in the Opinion of the

Michigan Court of Appeals. Therein the Court states that:

> "The issue on appeal is whether the Michigan Department of Treasury has the authority to impose an income tax on plaintiff's federal retirement benefits. Under the Michigan Income Tax Act, MCL 206.1 *et seq*; MSA 7.557(101) *et seq*, plaintiff was permitted to deduct from his taxable Michigan income no more than $7,500 of the amount he received in federal retirement benefits. MCL 206.30; MSA 7.557(130). By comparison, the same statutory provision permits state retirees receiving benefits from a public retirement system of the state or its political subdivisions to deduct retirement benefits in full. It is this differing tax treatment of retirement benefits which forms the basis of plaintiff's refund claims." (JS A2).

Stated alternatively, this appeal draws into question the authority of the Michigan legislature to separate into different classifications, for Michigan income tax purposes, those retirees



receiving benefits from the public retirement system of the State of Michigan or its political subdivision from all other retirees.

Appellant requested from Appellee a refund of Michigan income tax paid by him. His request was based upon his contention that federal retirement benefits were not subject to Michigan income tax. Appellant's refund request was denied and he subsequently filed suit in the Michigan Court of Claims asserting that the Michigan income tax was discriminatory as to source, and therefore unlawful under federal law. The Michigan Court of Claims ruled in favor of Appellee, holding that the imposition of the Michigan income tax upon retirement benefits received by federal retirees, while exempting

retirement benefits from public retirement systems of the state or its political subdivision, did not violate 4 U.S.C. 111 (JS A10-A13).

On appeal, the Michigan Court of Appeals upheld the trial court's judgment that Appellant, as a former federal employee, was not within the definition of employee as that term is used in 4 U.S.C. 111, and therefore, not entitled to the protection afforded by that statute. (JS A4). The Court also ruled that Appellant's contention that "...the imposition of a Michigan income tax on his federal retirement benefits is unlawful because it discriminates by source and burdens federal goverment activities..." was untenable. (JS A6).



The Appellant sought leave to appeal in the Michigan Supreme Court which denied Appellant's application. (JS A9). It is from this decision that Paul S. Davis appeals to this Court.

## ARGUMENT

**THE MICHIGAN INCOME TAX ACT, IN AFFORDING DIFFERING TREATMENT TO RETIREMENT AND PENSION BENEFITS RECEIVED BY STATE RETIREES AND RETIREES OF ITS POLITICAL SUBDIVISIONS IS A VALID EXERCISE OF THE STATE POWER TO CLASSIFY FOR TAX PURPOSES AND BEARS A RATIONAL RELATIONSHIP TO A LEGITIMATE STATE END.**

The Michigan Income Tax Act addresses the treatment of retirement and pension benefits at § 30(1)(h), MCL 206.30(1)(h); MSA 7.557(130) and provides as follows:

> (1) "Taxable income" in the case of a person other than a corporation, an estate, or a trust means adjusted gross income as defined in the internal revenue code subject to the following adjustments:
>
> * * *
>
> (h) Deduct to the extent included in adjusted gross income:
>
> (i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.
>
> (ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.
>
> (iii) Retirement or pension benefits from any other retirement or pension system as follows:
>
> (A) For a single return, the sum of not more than $7,500.00.
>
> (B) For a joint return, the sum of not more than $10,000.00.



For the years in question, the Appellant was permitted, under the Act, to deduct $7,500.00 of the amount received in Federal Civil Service retirement benefits. Mr. Davis claims that the entire amount of his retirement benefits should be exempt from state taxation.

The Appellant first argues that 4 U.S.C. 111 *supra*, applies. This section provides as follows:

> The United States consents to the taxation of pay or compensation for personal service as an *officer* or *employee* of the United States a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation. (Emphasis added).

For Federal Civil Service purposes, an *officer* is defined at 5 U.S.C. 2104 as follows:

> (a) For the purpose of this title, "officer," except as otherwise provided by this section or when specifically modified, means a justice or judge of the United States and an indivi-dual who is -- (1) required by law to be appointed in the civil service by one of the following acting in an official capacity -- (A) the President;
>
> (B) a court of the United States;
>
> (C) the head of an Executive agency; or
>
> (D) The Secretary of a military department;



> (2) engaged in the performance of a Federal Function under authority of law or an Executive act; and
>
> (3) subject to the supervision of an authority named by paragraph (1) of this section or the Judicial Conference of the United States, while engaged in the performance of the duties of his office.

Furthermore, for Federal Civil Service purposes, an *employee* is defined at 5 U.S.C. 2105 as follows:

> (a) For the purpose of this title, "employee," except as otherwise provided by this section or when specifically modified, means an officer and an individual who is -- (1) appointed in the civil service by one of the following acting in an official capacity-- (A) the President;
>
> (B) a Member or Members of Congress or the Congress;
>
> (C) a member of a uniformed service;
>
> (D) an individual who is an employee under this section;
>
> (E) the head of a Government controlled corporation; or

(F) the adjutant general designated by the Secretary concerned under section 709(c) of title 32;

(2) engaged in the performance of Federal function under authority of law or an Executive act; and

(3) subject to the supervision of an individual named by paragraph (1) of this subsection while engaged in the performance of the duties of his position.

Neither the Appellant nor the retirement benefits he receives because of his prior status as a federal employee comes within the term of 4 U.S.C. 111, *supra*. To avail himself of this statutory provision, Mr. Davis must be either an officer or employee of the United States. He is neither. Mr. Davis admits that he retired from United States government service but has never contended that he is presently an employee or officer of the United States government.



In *Lancellotti* v *Office of Personnel Management*, 704 F2d 91 (CA 3, 1983), the Circuit Court of Appeals concluded that a retired federal civil service employee was not an employee within the definition of employee for civil service purposes.

The definition of employee for Michigan income tax purposes is defined in Michigan Administrative Code 1979, R 206.2. Essentially, the rule provides that a relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the service, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. In other words, an employee is subject to the will and

control of the employer, not only as to what shall be done, but also as to how it shall be done. In addition, the employer possesses the right to discharge the employee.

This Court dealt with the definition of employee and the status of retired workers in *Allied Chemical and Alkali Workers of America v Pittsburgh Plate Glass Co*, 404 US 157; 92 S Ct 383; 30 L Ed 2d 341 (1971). In this case this Court defined employees as persons who worked for wages or salaries under direct supervision. The Court concluded that the ordinary meaning of employee does not include retired workers since retired employees have ceased to work for another.

Since the Appellant does not fit within the definition of either employer or



officer, as those terms are commonly used in applicable statutes and court decisions, the provisions of 4 U.S.C. 111, *supra*, simply do not apply.

The Michigan Court of Appeals agreed with this premise, holding that Appellant, under the Civil Service Retirement Act, was an annuitant, and defined as a *former* employee, 5 U.S.C. 8331(9). As such, Appellant as

> ... an annuitant is not considered an employee at the time he receives his annuity payments. Additionally, Plaintiff has failed to show any express legislative intent or case authority to give a broad construction to the term employee as contained in 4 U.S.C. 111 to encompass retired employees. Indeed, we believe that had Congress so intended it would have clearly so provided. (JS A6).

The Appellant also argues that the United States Supreme Court decision in

*Memphis Bank and Trust Co v Garner*, 459 US 392; 103 S Ct 692; 74 L Ed 2d 562 (1983), prohibits the State from taxing his retirement benefits. In *Memphis Bank and Trust Co, supra*, this Court determined that a Tennessee statute imposing a tax on the net earnings of banks doing business in the State of Tennessee which included interest received on obligations of the United States and its instrumentalities and of other states, but not interest earned on obligations of Tennessee and its political subdivisions, violated 31 U.S.C. 742 the predecessor of 31 U.S.C. 3124, *supra*. The Court found that the tax act, by favoring securities issued by Tennessee and its political subdivisions over federal obligations by including in the tax base income from federal obligations while excluding income



from otherwise comparable state and local obligations, improperly discriminated against the federal government and those with whom the federal government dealt.

The Appellant, to come within the confines of the decision reached in *Memphis Bank and Trust, supra*, must show that retirement benefits received under the United States' Government Civil Service Retirement Act are obligations of the United States government. 31 U.S.C. 3124, *supra*, provides in pertinent part as follows:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except-- (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax.

Clearly, the purpose of former section 742, now section 3124, was to prevent state taxation which diminished in the slightest degree the market value or investment attractiveness of obligations issued by the United States in its effort to secure necessary credit. See *Smith v Davis*, 323 US 111; 55 S Ct 157; 80 L Ed 107 (1944) and *American Bank & Trust Co v Dallas County*, 463 US 855; 103 S Ct 3369; 77 L Ed 2d 102 (1983). Congress intended such obligations to include bonds, treasury notes and other like obligations since these are the traditional instruments used by the federal government to secure credit. No case law exists interpreting this section or its predecessor to indicate there was any



intent by Congress to include, within the definition of obligations, benefits received under the Civil Service Retirement Act.

Appellant misconstrues the character of the case when he argues that the tax treatment afforded state retirees receiving retirement benefits from a public retirement system of the state or its political subdivision is discriminatory as compared to the tax treatment afforded all other retirees. This is not a discrimination case. It is a classification case.

There are a host of cases decided by this Court which uphold reasonable classifications for tax purposes. Among such cases are *Bell's Gap R Co v*

*Pennsylvania*, 134 US 232, 237; 10 S Ct 533; 33 L Ed 892, 895 (1899); *Magoun v Illinois Trust & Sav Bank*, 170 US 283, 293; 18 S Ct 594; 42 L Ed 1037 (1897); *Southwestern Oil Co v Texas*, 217 US 114, 121; 30 S Ct 496; 54 L Ed 688, 692 (1909); *Brown-Forman Co v Kentucky*, 217 US 563, 573; 30 S Ct 57; 54 L Ed 883 (1909); *Heisler v Thomas Colliery Co*, 260 US 245, 255; 43 S Ct 83; 67 L Ed 237, 241 (1922); *Oliver Iron Mining Co v Lord*, 262 US 172, 179; 43 S Ct 526; 67 L Ed 929, 936 (1922); *Stebbins v Riley*, 268 US 137, 142; 45 S Ct 424; 69 L Ed 884 (1924); *Ohio Oil Co v Conway*, 281 US 146, 159; 50 S Ct 310; 74 L Ed 775, 781 (1929); *State Tax Comrs v Jackson*, 283 US 527, 537; 51 S Ct 540; 75 L Ed 1248 (1930); *Allied Stores v Bowers*, 358 US 522; 79 S Ct 437; 3 L Ed 2d 480 (1959).



The Michigan Court of Appeals clearly recognized that this case involved classification for tax purposes when it applied an equal protection analysis, and correctly held that "...a statute will be upheld against an equal protection attack if the distinctions bear a rational relationship to a legitimate state end...." (JS A6-7).

In the instant case, two separate classes of retirees have been afforded different taxing treatment. The first class (and the much smaller of the two) includes those that receive retirement benefits from a public retirement system of the State of Michigan or its political subdivisions. The second class consists of all other retirees, which include Appellant.

The burden of showing that the classification lacks justification and that there is no conceivable basis which might support the classfication is upon Appellant. *Lehnhausen v Lake Shore Auto Parts Co*, 410 US 356; 93 S Ct 1001; 35 L Ed 2d 351 (1973).

As indicated by the Michigan Court of Appeals:

> Under the Michigan income tax system, a class distinction is made between state retirees and all other retirees, including federal retirees. In our opinion, the attracting and retaining of qualified employees is a legitimate state objective which is rationally achieved by a retirement plan offering economic inducements. One such inducement to state employees is tax exempt status for their retirement benefits. The State of Michigan, as an employer, owes a special responsibility to its employees, which it does not owe to federal employees. The full tax exemption permitted by the MITA is simply intended to recognize that income tax exemption is an integral part of the retirement benefits conferred upon state employees." (JS A7).



Appellant has failed to show that there is no reasonable basis for the statutory classification.

The jurisdictional statement does not present any substantial federal question. It is so wanting in substance in view of previous decisions of this Court sanctioning reasonable classifications for tax purposes as to warrant no further argument.

## RELIEF

WHEREFORE, Appellees respectfully submit that the question upon which this cause depends is so insubstantial as not to need further argument, and Appellees respectfully move this Court to dismiss this appeal, or, in the alternative, to affirm the order entered in this cause by

the Supreme Court of the State of Michigan.

Respectfully submitted,

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January 13, 1988

(3)

No. 87-1020



# In the Supreme Court of the United States

OCTOBER TERM, 1987

---

PAUL S. DAVIS, APPELLANT,

*v.*

MICHIGAN DEPARTMENT OF TREASURY

---

*ON APPEAL FROM THE COURT OF APPEALS OF MICHIGAN*

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**BRIEF FOR THE UNITED STATES AS AMICUS CURIAE**

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## QUESTION PRESENTED

Whether the doctrine of intergovernmental tax immunity, as embodied in 4 U.S.C. 111, prevents the State of Michigan from taxing the retirement benefits of former federal employees while exempting from taxation retirement benefits paid by the State and its political subdivisions.

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# In the Supreme Court of the United States

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No. 87-1020

PAUL S. DAVIS, APPELLANT,

*v.*

MICHIGAN DEPARTMENT OF TREASURY

*ON APPEAL FROM THE COURT OF APPEALS OF MICHIGAN*

**BRIEF FOR THE UNITED STATES AS AMICUS CURIAE**

This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

## STATEMENT

1. The State of Michigan exempts from taxation all pensions and retirement benefits paid to retired employees of the State of Michigan and its political subdivisions. Pensions and retirement benefits received from all other sources, including federal retirement benefits, are deductible only up to $7,500 for a single return and $10,000 for a joint return. See Mich. Comp. Laws Ann. § 206.30(1)(h) (West 1986 & Supp. 1988); Mich. Stat. Ann. § 7.557(130) (Callahan 1984).[1]

[1] Section 7.557(130) provides in relevant part:

(1) "Taxable income" in the case of a person other than a corporation, an estate, or trust means adjusted gross income as

Appellant is a retired federal employee living in Michigan. After paying state income tax on his federal pension for a number of years, appellant filed a complaint in the Michigan Court of Claims seeking a refund. He alleged that the Michigan Income Tax Act discriminated in favor of state retirement benefits and against federal retirement benefits in violation of 4 U.S.C. 111.[2]

2. On cross-motions for summary judgment, the Michigan Court of Claims concluded in an oral opinion that the Michigan Income Tax Act did not violate Section

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defined in the internal revenue code subject to the following adjustments:

* * * * *

(h) Deduct to the extent included in adjusted gross income:

(i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.

(ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.

(iii) Retirement or pension benefits from any other retirement or pension system as follows:

(A) For a single return, the sum of not more than $7,500.00.

(B) For a joint return, the sum of not more than $10,000.00.

[2] Section 111 provides in pertinent part:

The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States * * * by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.



111 because a retired federal civil servant is not currently an "officer or employee of the United States" within the meaning of that provision (J.S. App. A10-A11). The Michigan Court of Appeals affirmed (*id.* at A1-A8). The court agreed with the Court of Claims that someone who is not currently working for hire is not an "employee." Section 111, the court therefore concluded (J.S. App. A6), "has no application to [appellant], since [appellant] cannot be considered an employee within the meaning of that act."

The court of appeals further concluded that the Michigan Income Tax Act did not violate equal protection because the favorable treatment afforded to state retirees "bear[s] a rational relationship to a legitimate state end" (J.S. App. A6-A7). "In our opinion," the court stated (*id.* at A7), "the attracting and retaining of qualified employees is a legitimate state objective which is rationally achieved by a retirement plan offering economic inducements" such as "tax exempt status for their retirement benefits." The court justified the discrimination against similarly-situated federal employees by noting (*ibid.*) that "[t]he State of Michigan, as an employer, owes a special responsibility to its employees, which it does not owe to federal employees." Appellant's application for leave to appeal to the Supreme Court of the State of Michigan was denied (*id.* at A9).

## DISCUSSION

Section 111, by its plain terms, forbids discriminatory taxation of a retired federal employee who, through his pension, is still receiving "compensation for personal services as an officer or employee of the United States." If construed the same way as the nondiscrimination principle derived from the doctrine of intergovernmental tax im-

munity, Section 111 would appear to preclude a State from treating its own former employees more favorably for income tax purposes than former federal employees, absent a showing of significant differences between the two classes. Neither the courts below, nor the appellees have identified any such differences.

1. The Michigan court of appeals erred in concluding that appellant does not fall within the protection of Section 111. The court stated that as used in other contexts the term "employee" embraces only those who currently work for "hire" and that "a retired federal civil service employee is not to be considered an employee for civil service purposes." J.S. App. A4-A5. That is true (see, *e.g.*, *Chemical Workers* v. *Pittsburgh Glass*, 404 U.S. 157 (1971); *Lancellotti* v. *OPM*, 704 F.2d 91, 95 (3d Cir. 1983)); but it is also irrelevant. By its terms, Section 111 applies not just to the taxation of current employees of the United States, but to "the taxation of pay or compensation for personal service as an officer or employee of the United States." Appellant's pension is clearly compensation, albeit deferred compensation, "for" his years of "service as an * * * employee of the United States." See *e.g.*, *Zucker* v. *United States*, 758 F.2d 637, 639 (Fed. Cir.), cert. denied, 474 U.S. 842 (1985); *Kizas* v. *Webster*, 707 F.2d 524, 535-536 (D.C. Cir. 1983), cert. denied, 464 U.S. 1042 (1984); *Clark* v. *United States*, 691 F.2d 837, 842 (7th Cir. 1982). Appellant's pension therefore falls within the scope of Section 111. It follows that if the tax imposed by Michigan on that pension "discriminates" against federal retirees and in favor of state retirees based solely on "the source of the pay or compensation" (4 U.S.C. 111) then the Michigan tax is invalid.

2. Section 111 merely restates, in the context of taxation of compensation of federal employees by the States, the general constitutional rule requiring nondiscrimination in taxation of those dealing with the federal government. That rule, as applied to state taxation of federal payments to individuals, derives from the Supremacy Clause (Art. VI, Cl. 2). See *South Carolina* v. *Baker*, No. 94, Orig. (Apr. 20, 1988), slip op. 12 n.10. This Court's decisions construing the nondiscrimination principle in the context of intergovernmental tax immunities strongly suggest that the Michigan Income Tax Act "discriminates" against federal retirees within the meaning of 4 U.S.C. 111.



Under the doctrine of intergovernmental tax immunity, "States may not impose taxes directly on the Federal Government, nor may they impose taxes the legal incidence of which falls on the Federal Government." *United States* v. *County of Fresno*, 429 U.S. 452, 459 (1977) (footnote omitted). For many years this doctrine was interpreted broadly to prohibit state taxation of the salaries of officers and employees of the United States (*Dobbins* v. *Commissioners of Erie County*, 41 U.S. (16 Pet.) 435 (1842)) as well as federal taxation of the salaries of state officials. *Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1870). In *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938), however, this Court implicitly overruled *Day* by permitting the imposition of a federal income tax on employees of the New York Port authority. One year later, in *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466, 480 (1939), the Court expressly overruled *Dobbins*, declaring that "[t]he theory * * * that a tax on income is legally or economically a tax on its source, is no longer tenable." Since *Graves*, "[s]ubsequent cases have consistently reaffirmed the principle that a nondiscriminatory tax collected from private parties contracting with another government is constitutional" (*South Carolina* v. *Baker*, slip op. 15).

Congressional consideration and enactment of the predecessor of Section 111 responded to, and occurred during, the period of judicial abrogation of the *Day-Dobbins* doctrine. Following the Court's decision in

*Gerhardt*, Congress believed there was no longer any constitutional impediment to federal taxation of the income of state employees. In view of this development, Congress concluded that, in fairness, federal officers and employees should no longer remain immune from nondiscriminatory state taxation. Section 4 of the Public Salary Tax Act of 1939 (1939 Tax Act), ch. 59, 53 Stat. 574, the predecessor of Section 111, was designed to waive federal immunity to permit such taxation. See H.R. Rep. 25, 76th Cong., 1st Sess. (1939); S. Rep. 112, 76th Cong., 1st Sess. (1939).

Shortly before the 1939 Tax Act was approved by Congress, however, this Court decided *Graves*. Accordingly, the government's "consent[] to the taxation of pay or compensation for personal service as an officer or employee of the United States" in Section 111 was, in effect, merely a codification of the intervening decision overruling *Dobbins*. Nonetheless, in conditioning state taxation of federal employees' compensation on the State's "not discriminat[ing] against the officer or employee because of the source of the pay or compensation," Congress anticipated "[t]he nondiscrimination principle at the heart of modern intergovernmental tax immunity caselaw." *South Carolina* v. *Baker*, slip op. 19 n.14.[3]

3. Under the nondiscrimination principle in the law of intergovernmental tax immunity, a tax is invalid, even

[3] Congress may by legislation expand federal tax immunity beyond the confines of the constitutional doctrine. See *Baker*, slip op. 12 n.10 ("The Federal Government * * * possesses the power to enact statutes immunizing those with whom it deals from state taxation even if intergovernmental tax immunity doctrine would not otherwise confer an immunity."). Plainly, Section 111 was not designed to extend federal tax immunity. Nor, on the other hand, is there anything in the language or history of Section 111 to suggest that Congress intended further to limit federal tax immunity by drawing a new distinction between working federal employees and federal retirees when it authorized nondiscriminatory taxation.



if it is not imposed directly on the United States, " 'if it operates so as to discriminate against the Government or those with whom it deals.' " *Moses Lake Homes, Inc.* v. *Grant County*, 365 U.S. 744, 751 (1961) (quoting *United States* v. *City of Detroit*, 355 U.S. 466, 473 (1957)). See *South Carolina* v. *Baker*, slip op. 16-17; *Phillips Chemical Co.* v. *Dumas Independent School Dist.*, 361 U.S. 376, 387 (1960). Clearly, the burden of the tax in question here falls on those with whom the United States deals. Appellant's pension is subject to taxation solely because it is paid by the federal government rather than by the State or one of its subdivisions. It would appear, therefore, that the Michigan Income Tax Act operates in a discriminatory fashion in imposing a tax upon the retirement benefits of a former federal employee but not imposing it in similar circumstances upon the retirement benefits of former state employees. The principle of nondiscrimination precludes a State from imposing a tax on federal retirees if "it treats someone else better than it treats them." *Washington* v. *United States*, 460 U.S. 536, 545 (1983) (footnote omitted).

4. Appellees stress (Mot. to Dis. or Aff. 4) that federal retirees have not been singled out for a tax imposed on them alone. Rather, all pensions that are not paid by the State or one of its political subdivisions are treated alike. This Court's decisions, however, have rejected the notion that a state may avoid the charge of discriminatory taxation by treating the federal government or those with whom it deals the same as other private entities.

In *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392 (1983), Tennessee imposed a tax on the net earnings of banks doing business within the State, and defined net earnings to include income from obligations of the United States and its instrumentalities but to exclude interest earned on the obligations of Tennessee and its political

subdivisions. Although Tennessee treated income from obligations of the United States the same as income from private obligations, the tax was nonetheless declared invalid. "It is clear," the Court noted (*id.* at 398-399 (footnote omitted)), "that under the principles established in our previous cases, the Tennessee bank tax cannot be characterized as nondiscriminatory * * *. Tennessee discriminates in favor of securities issued by Tennessee and its political subdivisions and against federal obligations. The State does so by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals."[4]

Similarly, in *Phillips Chemical Co.* v. *Dumas Independent School Dist.*, *supra*, the State of Texas imposed a lesser tax burden on lessees of State property than it imposed on lessees of federal property. The Court held that the discriminatory tax was invalid despite the fact that "there appears to be no discrimination between the [federal] Government's lessees and lessees of private property" (361 U.S. at 381). The crucial point, the Court noted

[4] The Michigan court of appeals (J.S. App. A7-A8) sought to distinguish *Memphis Bank* on the grounds that Tennessee's tax was rendered invalid by a specific federal statute, 31 U.S.C. (1976 ed.) 742, which prohibits all but nondiscriminatory franchise or nonproperty taxes on federal obligations. See also Mot. to Dis. or Aff. 14-18. In analyzing Section 742, however, the Court stated that it viewed that statute "as principally a restatement of the constitutional rule" (459 U.S. at 397) and proceeded to scrutinize the Tennessee tax under the general doctrine of intergovernmental tax immunity (*id.* at 397-398). *Memphis Bank* is therefore directly on point.



(*id.* at 382), was that the federal lessee "would not be taxed at all if its lessor were the State or one of its political subdivisions instead of the Federal Government. The discrimination against the United States and its lessee seems apparent." "[I]t does not seem too much," the Court concluded (*id.* at 385), "to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself."

Under *Memphis Bank* and *Phillips Chemical Co.*, it would appear that the State of Michigan is discriminating in favor of pensions granted by the State and its political subdivisions and against federal pensions. "The State does so by including in the tax base income from federal [pensions] while excluding income from otherwise comparable state and local [pensions]" (*Memphis Bank*, 459 U.S. at 398 (footnote omitted)). The federal pensioner "would not be taxed at all if its [former employer] were the State or one of its political subdivisions instead of the Federal Government. The discrimination against the United States and its [retirees] seems apparent." *Phillips Chemical Co.*, 361 U.S. at 382.

5. The Michigan court of appeals, without denying that the Michigan Income Tax Act discriminates against former federal employees, sought to justify that discrimination under traditional equal protection principles on the ground that the statutory classification "bear[s] a rational relationship to [the] legitimate state end * * * [of] attracting and retaining * * * qualified employees" (J.S. App. A6-A7). But this Court has already made it clear that ordinary equal protection principles "are not necessarily controlling where problems of intergovernmental tax immunity are involved" (*Phillips Chemical Co.*, 361 U.S. at 385). General policy considerations are not sufficient to justify discriminatory taxation against

those who deal with the federal government. "The imposition of a heavier tax burden on [those who deal with the federal government] than is imposed on [those who deal with the State government] must be justified by significant differences between the two classes" (*id.* at 383). The court of appeals made no attempt to justify the differential treatment of state and federal retirees under this exacting standard.

The fact that the discrimination at issue here gives the State a competitive edge does not distinguish it from any other special tax benefit given to those who deal with the State rather than the federal government and does not justify the discrimination. In *Phillips Chemical Co.,* 361 U.S. at 384, the Court expressly rejected a similar justification proffered by the State that favorable tax treatment for its lessees would "facilitate the leasing of its own land." See *United States* v. *City of Manassas,* 830 F.2d 530, 534 (4th Cir. 1987) (the only "justification" that would support a statute discriminating against those who deal with the United States is "a showing that the two classes of users, from federal and state sources, are not similarly situated, so that in essence there is no discrimination"), aff'd, No. 87-1117 (Apr. 25, 1988).

Nor can the exemption of state pension benefits from state taxation be justified on the ground that the State could accomplish the same result by increasing the amount of benefits paid to retirees. If the State increased pension benefits, this in turn would increase the federal tax liability of state retirees. Thus, in order to confer the same monetary advantage upon state retirees, the State would have to pay out more in additional benefits than it foregoes in lost tax receipts.[5] In *Phillips Chemical Co.,* the

[5] The differential impact in terms of federal taxation is reduced to some extent by the fact that the option of increasing pension benefits would yield not only higher federal taxes but also higher state taxes,



Court rejected an analogous contention to the effect that differential treatment of lessees of state property could be justified because "the State can collect in rent what it loses in taxes from its own lessees" (361 U.S. at 384).

In sum, contrary to the decision below, Section 111 applies to all persons receiving pay or compensation for personal services rendered to the United States, whether that pay or compensation is for current services or is deferred compensation for services performed in the past. And if the nondiscrimination provision of Section 111 is interpreted in light of this Court's intergovernmental tax immunity decisions, then a State may not treat its own former employees more favorably for income tax purposes than former federal employees, unless there are significant differences that justify treating these two classes of former employees unequally. Neither the lower courts nor appellees have advanced any distinction between state and federal retirees that would appear to qualify under this standard. The jurisdictional statement therefore presents a substantial federal question that ought to be resolved by this Court.[6]

which are generally deductible from income for purposes of determining federal tax liability. But because state income tax rates are invariably lower than federal income tax rates, the higher deduction would never completely offset the additional federal tax liability.

[6] Appellant has standing to challenge the Michigan Act, even though the State could respond in a number of ways to a judgment invalidating the differential treatment of former state and federal employees, including eliminating the special exemption for former employees of the State and its political subdivisions, as well as extending this exemption to former federal employees. See, e.g., *Heckler* v. *Mathews,* 465 U.S. 728, 737-740 (1984); *Orr* v. *Orr,* 440 U.S. 268, 271-273 (1979). As in cases claiming a denial of equal protection, the appropriate remedy here "is a *mandate* of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class." *Mathews,* 465 U.S. at 740 (emphasis in original).

## CONCLUSION

Probable jurisdiction should be noted.

Respectfully submitted.

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JUNE 1988

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(4)

No. 87-1020



IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

PAUL S. DAVIS, Appellant

v.

STATE OF MICHIGAN, DEPARTMENT OF THE TREASURY, Appellee

ON APPEAL FROM THE
COURT OF APPEALS OF MICHIGAN

# JOINT APPENDIX

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APPEAL DOCKETED DECEMBER 21, 1987

PROBABLE JURISDICTION NOTED JUNE 27,1988

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RELEVANT DOCKET ENTRIES

MICHIGAN COURT OF CLAIMS
File No. 84-9451

| | |
|---|---|
| 1984 | |
| July 11 | Complaint for Refund of Income Taxes filed. |
| July 24 | Answer of Defendant filed. |
| 1985 | |
| Sept 23 | Motion of Plaintiff for Summary Disposition filed. |
| Oct 25 | Brief of Defendant in Response to Motion filed. |
| Oct 30 | Order Granting Plaintiff Leave to file Amendment and Supplement to Complaint. |
| Oct 30 | Amendment and Supplement to Complaint filed. |
| Oct 30 | Memorandum in Support of Plaintiff's Motion for Summary Judgment filed. |
| Oct 30 | Hearing before Judge James R. Giddings on Motion for Summary Judgment, and Oral Opinion of Court. |
| Nov 7 | Order Granting Summary Disposition in favor of Defendant. |
| Nov 18 | Claim of Appeal by Plaintiff filed. |

MICHIGAN COURT OF APPEALS
File No. 88776

| | |
|---|---|
| 1985 | |
| Nov 18 | Claim of Appeal filed. |
| 1986 | |
| April 30 | Appellant's Brief filed. |
| July 1 | Appellee's Brief filed. |
| 1987 | |
| Jan 12 | Oral Argument before Court. |
| May 5 | Opinion of Court. |
| May 11 | Application for Leave to Appeal to Michigan Supreme Court, filed. |
| Dec 4 | Notice of Appeal to United States Supreme Court, filed. |

MICHIGAN SUPREME COURT
File No. 80836

| | |
|---|---|
| 1987 | |
| May 11 | Application for Leave to Appeal filed. |
| May 29 | Brief of Defendant in Opposition to Application, filed. |
| Sept 28 | Order Denying Application for Leave to Appeal. |

STATE OF MICHIGAN

IN THE COURT OF CLAIMS

PAUL S. DAVIS, Plaintiff, v.

STATE OF MICHIGAN, DEPARTMENT OF THE TREASURY, Defendant.

File No. 84-9451

---

COMPLAINT FOR REFUND OF INCOME TAXES (filed July 11, 1984), as amended and supplemented by AMENDMENT AND SUPPLEMENT TO COMPLAINT (filed October 30, 1985).

Now comes the Plaintiff, Paul S. Davis, appearing *pro se*, and respectfully represents unto this Honorable Court as follows:

(1) The Plaintiff is a resident of East Lansing, Michigan, and has been a resident of the State of Michigan since 1967. During that period, and specifically for each of the years from 1979 to 1983, inclusive, he has paid Michigan Income Taxes, pursuant to the Michigan

Income Tax Law (Public Act of 1967, No. 281; M.C.L. 206.1 et seq.).

The Defendant, Department of the Treasury of the State of Michigan, is responsible for the collection of taxes of the State of Michigan, and specifically for the collection of taxes under the Michigan Income Tax Law.

(3) Plaintiff is a former employee of the United States Government, and served as such from 1938 to 1942, from 1946 to 1956, and from 1974 to 1980. Based on his Government service Plaintiff has for some years received Federal Civil Service Retirement benefits, authorized pursuant to the Civil Service Retirement Act (Act of July 31, 1956, as amended; 5 U.S.C. 8331 et seq.). For each of the years from 1979 to 1983 Plaintiff had retirement benefits in the following amounts:

| | |
|---|---|
| 1979 | $ 5,442.00 |
| 1980 | 5,052.00 |
| 1981 | 11,569.00 |
| 1982 | 17,994.00 |
| 1983 | 18,832.00 |

(4) In filing his Michigan Income Tax returns for each of the foregoing tax years Plaintiff followed the instructions accompanying the forms prescribed by the Defendant, in accordance with Section 30 of the Michigan Income Tax Law, and included all of his Federal Retirement benefits in his taxable income. In each of these years Plaintiff had other retirement benefits from non-Governmental sources exceeding the exemption of $7500 authorized by Section 30(1)(h)(iii)(A) of that Law.

(5) Subsequent to the decision of the United States Supreme Court in Memphis Bank & Trust Co. v. Garner, __ U.S. __, 103 S.Ct. 682, 74 L.Ed.2d

562 (1983), Plaintiff filed Amended Returns for the years 1979 to 1982, excluding his Federal Retirement benefits from his taxable income. In those Amended Returns and an accompanying Petition and Claim, Plaintiff petitioned for refunds of his Michigan Income Taxes paid for those years, in so far as based on Federal retirement benefits. By letter dated April 13, 1984 the Defendant denied Plaintiff's Claim for refund of such taxes.

(6) Plaintiff filed his 1983 Michigan Income Tax Return on or about April 14, 1984. In that Return he included his Civil Service retirement benefits, in the amount of $18,832.00, and paid the tax thereon under protest, amounting to $1251.47. Subsequently Plaintiff filed an Amended Return for his 1983 Income Tax, together with a Petition and Claim for refund of the amount paid under protest.

(7) The amounts of the Michigan Income Taxes paid by Plaintiff, based on Plaintiff's Civil Service Retirement benefits, for which Plaintiff filed petitions and claims for refunds, were for each of the foregoing years as follows:

| | |
|---|---|
| 1979 | $ 250.33 |
| 1980 | 232.39 |
| 1981 | 532.17 |
| 1982 | 917.69 |
| 1983 | 1,251.47 |
| Total | $ 3,184.05 |

(8) Plaintiff states that the Federal Civil Service Retirement benefits which he receives from the United States Government, since they represent compensation for services, are not legally taxable under the Michigan Income Tax Law. Under accepted principles of inter-governmental immunity and Federal aupremacy compensation of

Federal employees may be taxed by a State only in accordance with specific authorization of the Federal Government.

(9) In the Public Salary Tax Act of 1939 (Act of April 12, 1939, Chapter 59, Section 4; 58 Stat. 575), now substantially codified in 4 U.S.C. 111, the United States consented to "the taxation of pay and compensation for personal services as an officer or employee of the United States." However this consent is subject to the following express qualification, set forth in that statute: "if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.' (Underscoring added).

(10) In the Michigan Income Tax Act, the Legislature has completely exempted from the Michigan Income Tax any "Retirement or pension benefits received from a public retirement system of or created

by an act of this state or a political subdivision of this state.' (MCL 206.30 (1)(h)(i)). The effect of this exemption is to create a discrimination against Federal retirement annuitants based on the <u>source</u> of their pensions, since there is no comparable exemption for Federal Retirement benefits.

(11) Plaintiff also asserts that the payment of United States Retirement benefits constitutes the payment of an obligation of the United States, which is specifically exempted from State taxation under 31 U.S.C. 3124, and is also exempted from Michigan Income Tax under Section 30(1)(e) of the Michigan Income Tax Act (MCL 206.30(1)(e)).

(12) Plaintiff states that he is entitled to refunds of his Michigan Income Taxes for the years 1979 to 1983, in so far as such taxes have been paid

and collected on the basis of income from Federal Retirement benefits, in the amounts hereinbefore set forth, aggregating $3,184.05.

(13) Subsequent to the filing of the Complaint herein Plaintiff filed his Michigan Income Tax return and paid his Income Tax for the year 1984. That return included as part of his income the amount of $19,068.00, representing Federal Civil Service Retirement benefits, on which the Michigan Income Tax was $1,115.48,which tax the Plaintiff paid. Plaintiff thereafter filed an Amended Return for 1984 requesting a refund of said amount of $1,115.48.

WHEREFORE, Plaintiff prays that this Honorable Court:

(A) Adjudge, determine and decree that the Michigan Income Tax Law, in so far as it purports to tax income from Federal Civil Service Retirement benefits, is invalid and unconstitutional.

(B) Enter judgment for the Plaintiff against the Defendant in the sum of $4,299.53,being the amount of Michigan Income Taxes paid by Plaintiff, based on Federal Retirement benefits, for the years 1979 to 1984, inclusive, together with interest.

Dated: July 11, 1984. As amended and supplemented: October 25, 1985.

[Subscription, address, etc.]

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ORAL OPINION OF COURT OF CLAIMS, October 30, 1985 [set forth in Jurisdictional Statement, App. C]

ORDER OF COURT OF CLAIMS, November 7, 1985 [set forth in Jurisdictional Statement, App. D]

OPINION OF COURT OF APPEALS, May 5, 1987 [set forth in Jurisdictional Statement, App. A]

ORDER OF MICHIGAN SUPREME COURT DENYING LEAVE TO APPEAL, September 28, 1987 [set forth in Jurisdictional Statement, App.B]

(5)

NO. 87-1020



IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

PAUL S. DAVIS,

Appellant

v.

STATE OF MICHIGAN,
DEPARTMENT OF THE TREASURY,

Appellee

ON APPEAL FROM THE
COURT OF APPEALS OF MICHIGAN

# BRIEF FOR APPELLANT

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## QUESTION PRESENTED

Whether Section 30(l)(h) of the Michigan Income Tax Act [MCLA 206.30(l)(h); MSA 7.557(130)(l)(h)],which completely exempts from Michigan income tax retirement benefits paid to retirees of the State and its political subdivisions, but gives no equivalent exemption to retirement benefits paid to retirees of the Federal Government, is invalid, as applied to Federal retirees, as being in violation of the Federal statute (4 U.S.C. 111), which permits State taxation of compensation of Federal employees only if the taxation does not discriminate against the employee because of the source of the compensation.

## PARTIES

The names of all parties to the proceeding are set forth in the caption.

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CASES:

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

---

PAUL S. DAVIS, Appellant

v.

STATE OF MICHIGAN, DEPARTMENT OF THE TREASURY, Appellee

---

ON APPEAL FROM THE COURT OF APPEALS OF MICHIGAN

---

**BRIEF FOR APPELLANT**

---

Paul S. Davis, Appellant herein, a member of the Bar of this Court, appearing *pro se*, appeals to this Court from the final judgment of the Court of Appeals of Michigan, dated May 5, 1987.

## OPINIONS AND JUDGMENTS BELOW

Davis v. Department of Treasury, 160 Mich. App. 98, 408 N.W. 2d 433 (May 5, 1987), set forth in the Jurisdictional Statement (hereafter abbreviated "J.S."), Appendix A, pages A1 to A8.

Davis v. Department of Treasury, 429 Mich. 854 (September 28, 1987), leave to appeal denied; no opinion. Copy of Order is set forth in J.S., Appendix B, page A9.

Davis v. Department of Treasury, Michigan Court of Claims, Case No. 84-9451 (not reported). Oral Opinion is set forth in J.S., Appendix C, pages A10 to A11; Order is set forth in J.S., Appendix D, pages A12 to A13.

## GROUND FOR JURISDICTION

Appellant invokes the jurisdiction of this Court pursuant to 28 U.S.C. 1257(2). The issue in this case in-

volves the validity of the Michigan Income Tax as applied to Federal retirement benefits, in the light of the Federal statute (4 U.S.C. 111). This issue was specifically raised in the Complaint (Joint Appendix, hereafter referred to as "J.A.", pages 8-10). It was expressly considered and decided by the Michigan Court of Claims and the Michigan Court of Appeals (J.S. pages A10-11 and A1-8, especially A6-7).

Accordingly, since the case has drawn into question the validity of the Michigan law on the ground of its repugnancy to the Federal statute, and the Court of Appeals decision was in favor of the validity of the Michigan law, this Court has jurisdiction under 28 U.S.C. 1257(2).

Appellant filed his Notice of

Appeal on December 4, 1987 (J.S. A14-15). He docketed the case in this Court by filing his Jurisdictional Statement on December 21, 1987. Both of these dates are prior to 90 days from September 28, 1987, the date of the Michigan Supreme Court's order denying leave to appeal (J.S. A9).

STATUTES INVOLVED

Michigan Income Tax Act, Section 30(1)(h) [1967 Public Act No. 281; M.C.L.A. 206.30 (1)(h); M.S.A. 7.557(130)(1)(h)].

4 U.S.C. 111 (Section 4 of Act of April 12, 1939, codified on September 6, 1966; 80 Stat. 808).

Federal Civil Service Retirement Act (5 U.S.C. 8331 et seq.), Section 8339(a).

The foregoing statutory provisions are set forth in J.S., Appendix F, pages A16-17. 4 U.S.C. 111 is also set forth in the text below, page 14.

## STATEMENT OF THE CASE

Appellant is a former employee of the United States Government, and served as such from 1938 to 1942, from 1946 to 1956, and from 1974 to 1980 (J.A. 4). Based on his Government service, Appellant receives Federal Civil Service Retirement benefits, authorized pursuant to the Federal Civil Service Retirement Act (Act of July 31, 1956, as amended; 5 U.S.C. 8331 _et_ _seq_.)(J.A. 4).

In filing his Michigan Income Tax returns for each of the tax years 1979 to 1984, inclusive, Appellant followed the instructions accompanying the forms prescribed by the Michigan Department of the Treasury, Appellee herein, and included all of his Federal retirement benefits in his taxable income (J.A. 5). Subsequently Appellant filed amended tax returns for

each of these years, in which he excluded his Federal retirement benefits from his taxable income (J.A. 6, 10). In the amended returns and accompanying petitions and claims to the Michigan Revenue Commissioner Appellant petitioned for refunds of his Michigan income tax paid for those years, in so far as based on his Federal retirement benefits (J.A. 6, 10). The Revenue Commissioner denied Appellant's claims for refund. The amounts of such claims for refund for the years 1979 to 1984 aggregated $4,299.53 (J.A. 10, 11).

Following denial of his claims for refund, Appellant filed in the Michigan Court of Claims his Complaint seeking recovery of the Michigan income taxes paid on his Federal retirement benefits (J.A. 1,3-11). In his claims for refund and in the Court of Claims Appellant relied on the Federal statute,

4 U.S.C. 111, and took the position that the Michigan Income Tax Act, by completely exempting Michigan retirement benefits while taxing Federal retirement benefits, was invalid as being inconsistent with the Federal statute (J.A. 7-11).

In the Court of Claims the case was heard on motions for summary disposition, since there was no dispute on the facts (J.A. 1). After the filing of briefs and argument, the Judge of the Court of Claims rendered an Oral Opinion, on October 30, 1985, in favor of the Appellee (J.S., Appendix C, pages A10-11). The Michigan Court of Appeals affirmed the Court of Claims (J.S., Appendix A, pages A1-8). The Michigan Supreme Court denied leave to appeal (J.S., Appendix B, page A9).

Thereafter Appellant filed his Notice of Appeal (J.S., Appendix E, pages A14-15; J.A. 1), and docketed his appeal in this Court.

## SUMMARY OF ARGUMENT

Under the doctrine of intergovernmental tax immunity, developed by this Court in the 19th Century, it was established that States could not tax Federal salaries and that the Federal Government could not tax State salaries. Decisions of the Court in this Century gradually limited these principles.

In the Public Salary Tax Act of 1939 Congress specifically applied the Federal Income Tax to State and municipal salaries. Section 4 of that Act (now codified as 4 U.S.C. 111) authorized States to tax the salaries and compensation of Federal officers and employees. However, the latter provision specifically stated that any such State tax must not discriminate because of the source of the pay or compensation.

The present case involves the Michigan Income Tax as applied to Appellant's Federal retirement benefits. Although the State contends that the Federal law applies only to salaries of present Federal employees, Appellant submits that since the statute refers to pay or compensation, and since Federal retirement benefits are based on years of service and past compensation, they are a form of deferred compensation and are within the scope of the statute.

Michigan's Income Tax Act exempts the full amount of the retirement benefits of State and municipal retirees, but taxes Federal retirement benefits subject only to a limited exemption. Accordingly the Michigan Income Tax Act discriminates because of the source of the compensation, and therefore is in violation of 4 U.S.C. 111.

## ARGUMENT

**I. THE FEDERAL STATUTE, 4 U.S.C. 111, PERMITS STATE TAXATION OF FEDERAL CIVIL SERVICE RETIREMENT BENEFITS, BUT ONLY IF THE STATE DOES NOT DISCRIMINATE BECAUSE OF THE SOURCE OF THE BENEFITS.**

The governing statute in this case is 4 U.S.C. 111, which permits non-discriminatory State taxation of Federal compensation. This law was originally enacted in 1939 as Section 4 of the Public Salary Tax Act (53 Stat. 574, 575; Chapter 59, Public Laws of the 76th Congress, First Session, approved April 12, 1939).

Under earlier principles of intergovernmental tax immunity, established by this Court commencing in 1819 in McCulloch v. Maryland, 4 Wheat. (17 U.S.) 316, Federal obligations and compensation were considered constitutionally exempt from State taxation, and

reciprocally State and municipal obligations and compensation were exempt from Federal taxation (Dobbins v. Commissioners of Erie County, 16 Pet. (41 U.S.) 435 (1842) and Collector v. Day, 11 Wall. (78 U.S.) 113 (1870)).

Decisions of this Court in the 20th Century gradually limited the scope of intergovernmental tax immunity. Thus in South Carolina v. United States, 199 U.S. 437 (1905), it was held that the immunity did not extend to a State-operated liquor business, and in Helvering v. Powers, 293 U.S. 214 (1934), the Court sustained application of the income tax to the salary of a transportation utility executive where the utility was owned by a State.

On April 25,1938 President Franklin D. Roosevelt sent a Message to Congress urging legislation applying the Federal Income Tax to income from State and municipal securities and to salaries of

State and local employees (83 Cong. Rec. 5693). A few weeks later, on May 23, 1938, this Court decided Helvering v. Gerhardt, 304 U.S. 405, which upheld applying the Federal Income Tax to an employee of the Port of New York Authority.

Early in the next session of Congress, on January 19, 1939, President Roosevelt sent another Message to Congress reaffirming his earlier Message (84 Cong. Rec. 467). Legislation to carry out his recommendations with respect to Federal and State salaries was promptly introduced and was the subject of hearings and debates in Congress.

While the bill was pending, this Court decided Graves v. New York ex rel. O'Keefe, 306 U.S.466 (March 27, 1939). In that case the Court specifically overruled Collector v. Day, supra, and held that the Federal Income Tax applied to all State and municipal officers and employees. It may be noted that in the

Graves case Solicitor General Jackson appeared for the United States as amicus curiae, and presented a strong argument favoring State taxation of Federal employees' salaries and urging that Collector v. Day be overruled (306 U.S. at pages 472-75).

The Public Salary Tax Act (cited above, page 10) was approved on April 12, 1939. It specifically subjected compensation paid by State and local governments to the Federal Income Tax. However, Congress did not accept the President's recommendation to tax the income from State and municipal bonds.

Section 4 of this Act, which is involved in the present case, granted the consent of Congress to the State taxation of Federal pay or compensation, provided that the tax does not discriminate against the officer or employee because of the source of the pay or compensation. In effect, Congress in

this legislation confirmed the principles of the Graves case, but specified that any State tax must not be discriminatory.

The text of Section 4, codified (with minor changes not here material) in the United States Code as 4 U.S.C. 111, is as follows:

> "The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation." (Underscoring added).

Application of 4 U.S.C. 111 to the present case will next be discussed.

## II. FEDERAL RETIREMENT BENEFITS ARE WITHIN THE SCOPE OF 4 U.S.C. 111.

Appellant's Civil Service Retirement benefits are paid pursuant to the Civil Service Retirement Act (Act of July 31, 1956, as amended; 5 U.S.C. 8331 et seq.).

The amount of Appellant's retirement benefit is computed under the provisions of 5 U.S.C. 8339(a), and is based on salary and years of service (see J.S. App. F). As stated by the Court of Appeals for the Sixth Circuit in Hogan v. United States, 513 F. 2d 170, 172 (1975), "the amount of the annuity payable on retirement is "directly related to the earnings and years of service of the individual employee." (Underscoring added).

Appellee argued in the Michigan courts that since Appellant is no longer an officer or employee of the Federal Government the provisions of 4 U.S.C. 111 do not apply to him. The Court of Claims and the Court of Appeals accepted that argument. It is submitted that such an interpretation is incorrect, since the scope of the statute is not limited to current Federal rmployees.

The consent expressed in 4 U.S.C.

111 is not phrased in terms of the pay or compensation <u>of</u> a present officer or employee. On the contrary, it expressly covers the "pay or <u>compensation</u> for <u>personal</u> <u>services</u> <u>as</u> an officer or employee of the United States." (Underscoring added). Appellant's retirement annuity is clearly a part of his compensation for his past Government work as an employee of the United States.

The word "compensation" is a broad concept, and is not limited to current salary. In <u>Clark</u> <u>v</u>. <u>United States</u>, 691 F. 2d 837 (1982), the Court of Appeals for the Seventh Circuit reviewed the history and purposes of the Federal Retirement law. The Court stated that the purpose of this statute "is to allow the federal government to compete with the private sector by offering

federal employees an attractive retirement plan." (691 F. 2d at page 842). The Court's opinion went on to refer to the retirement system as "a <u>deferred</u> <u>compensation</u> plan," designed to encourage employees to enter and remain in Government service (page 842; underscoring added).

Similarly, in <u>Kizas</u> <u>v</u>. <u>Webster</u>, 707 F. 2d 524, 536 (D.C. Circuit, 1983), the Court referred to retirement benefits as being one incident of employee compensation. Again, in the recent decision of the Court of Appeals for the Federal Circuit in <u>Zucker</u> <u>v</u>. <u>United</u> <u>States</u>, 758 F. 2d 637, 639 (1985), cert. den. 474 U.S. 842 (1985), the Court referred to the legislative history of the Retirement Act, during which the pension benefits were characterized as "deferred wages."

The foregoing authorities demonstrate that Federal Retirement benefits constitute additional compensation for past services to the Government. Accor-

dingly they are clearly within the scope of the language of 4 U.S.C. 111, covering "compensation for personal service as an officer or employee of the United States," even though not actually paid until after retirement.

### III. THE MICHIGAN INCOME TAX ACT DISCRIMINATES AGAINST FEDERAL RETIREES BECAUSE OF THE SOURCE OF THEIR COMPENSATION, IN VIOLATION OF 4 U.S.C. 111.

As set forth above, 4 U.S.C. 111 authorizes State taxation of Federal compensation only when the tax "does not discriminate" because of the "source" of the compensation. The legislative history of this Act shows that Congress was concerned that its consent to State taxation would be granted only where the tax was non-discriminatory.

The House of Reprentatives Committee Report emphasized that the consent of Congress to State taxation of Federal

compensation was "expressly confined to taxation which does not discriminate against such officers or employees because of the source of their compensation." (House of Representatives, Committee on Ways and Means, 76th Congress, 1st Session, Report No. 26, on H.R. 3790, February 7, 1939, page 5).

When the bill was before the Senate Committee Senator Gerry of Rhode Island asked for an explanation of the non-discrimination language in this provision. Senator Prentiss Brown, the Senator in charge of the legislation, stated in reply (Senate Hearings on Public Salary Tax Act, H.R. 3790, February 21, 1939, at page 21):

> "I would say, Senator Gerry, that it is an analogous to the subject of the taxation of national bank stock by a State. We authorized taxation by the State of Rhode Island of any stock held by citizens of Rhode Island in a national bank, and we provide in it that that taxation must be on the same terms and conditions

> as taxation of State bank stock by the State of Rhode Island, and I think the idea in this bill is to permit that kind of income tax legislation."

The Report of the Senate Committee stated that the Federal consent to such taxation was to apply only "if such taxation does not discriminate against such officer or employee because of the source of such compensation." (Senate Committee on Finance, 76th Congress, 1st Session, Report No. 112, February 24, 1939, page 11). */

The Michigan Income Tax Act discriminates against Federal retirees because of the source of their compensation, in violation of the express language of 4 U.S.C. 111. The Michigan Act taxes Federal retirement benefits,

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*/ The Senate Committee Report contains an extensive discussion of the constitutional aspects of the legislation, and reviews the various Supreme Court cases on intergovernmental tax immunities as of that time (pages 4-10).

subject only to a limited exemption set forth in subparagraph (iv) of Section 30(1)(h) of that Act (J.S. App. F, page A16). On the other hand, the Michigan Act expressly exempts the full amount of retirement benefits received from a public retirement system of the State or any of its political subdivisions (subparagraph (i) of Section 30(1)(h)). Clearly this constitutes a discrimination against Federal retirees based on the source of their compensation.

In Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983), this Court held invalid a Tennessee statute taxing bank earnings, which was defined to include interest on United States obligations but did not include interest on State obligations. The Court held that this statute discriminated "in favor of securities issued by Tennessee and its political subdivisions and against

federal obligations," and that this constituted an unconstitutional discrimination. The Court concluded that "the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals." (459 U.S. at 399).

Appellant had cited the Memphis case before the Michigan Court of Claims and the Michigan Court of Appeals. In its opinion below the Michigan Court of Appeals suggested that this precedent was inapplicable in the present case because Federal obligations are not involved. Appellee has made a similar argument in this Court in his Motion to Dismiss or Affirm (pages 14-18).

Appellant does not contend that his retirement benefits are to be treated as a Government security of which the interest is specifically exempt under another Federal statute (31 U.S.C. 3124), quoted in Appellee's Motion

to Dismiss (pages 16-17). Appellant does assert, however, that the Memphis case is a clear precedent showing a discrimination against Federal retirees, in violation of 4 U.S.C. 111.

The Michigan Court of Appeals in its Opinion in this case discussed the distinction in the Michigan Tax Act "between State retirees and all other retirees," and treated it in terms of the equal protection clause (160 Mich. App. at pages 104-05; J.S., pages A6-A7). The Court found a "legitimate state objective"(page 105; J.S.,page A7). Appellee in his Motion to Dismiss or Affirm has also argued that the case is one of "reasonable classification" and "not a discrimination case" (Motion, pages 18-21).

However, the language of 4 U.S.C. 111 does not permit classifying State and Federal retirees differently.

Appellant does not question the right of the State to favor its own retirees as against non-Federal retirees. But Appellant submits that the Federal law (4 U.S.C. 111) forbids discrimination against Federal retirees.

Other decisions of this Court emphasize that a State may not discriminate against Federal activities. Phillips Chemical Co. v. Dumas Independent School District, 361 U.S. 376 (1960), cited in the Memphis case, supra, invalidated a tax which was imposed on lessees of property owned by the Federal Government, but which exempted lessees of property owned by the State and its political subdivisions. The Court considered this to be a "substantial and transparent" discrimination against the Government and its lessees (361 U.S. at page 387).

Similarly, in Moses Lake Homes v. Grant County, 365 U.S. 744 (1961),

this Court held invalid a tax on lessees of Federal property, where their leaseholds were assessed at the full value of the land and improvements, but other leaseholds were assessed at their fair market value excluding the value of the improvements.

In the recent case of City of Manassas v. United States, ___ U.S. ___, 108 S.Ct. 1586, 99 L.Ed.2d 884 (April 25, 1988; No. 87-1117) this Court affirmed the decision of the Court of Appeals for the Fourth Circuit in United States v. City of Manassas, 830 F.2d 530 (1987). That case held invalid personal property taxes imposed by a Virginia municipality on property furnished by the United States for use by a Government contractor. The Virginia statute expressly exempted from this tax property owned by the Virginia Port Authority and some local

transportation districts. The Court of Appeals relied particularly on the Phillips case, supra, and held that the discrimination was not justified and that the tax was invalid.

In South Carolina v. Baker, ___ U.S. ___, 108 S.Ct. 1355, 99 L.Ed.2d 592; 56 L.W. 4311 (April 20, 1988; No. 94, Orig.), the Opinion of the Court analyzed past cases on intergovernmental tax immunity (Part III). In summarizing the current law, the Court pointed out that taxes may be imposed against parties doing business with the Government "as long as the tax does not discriminate against the United States or those with whom it deals" (99 L.Ed.2d at page 610; 56 L.W. at page 4316).

The foregoing authorities demonstrate that the Michigan Income Tax Act unlawfully discriminates against Federal retirees, and is therefore in violation of 4 U.S.C. 111.

## CONCLUSION

On the basis of the facts and the law, it is submitted that the Michigan Income Tax Act, in taxing Federal retirement benefits while exempting those of State retirees, creates an unlawful discrimination because of source, in violation of 4 U.S.C. 111.

Accordingly this Court should reverse the decision of the Michigan Court of Appeals and remand the case with directions to (1) decree that the Michigan Income Tax Act is invalid in so far as it taxes Federal retirement benefits; and (2) enter judgment for Appellant against Appellee, for the taxes paid on such benefits, commencing with the tax year 1979, together with statutory interest.

Respectfully submitted,

PAUL S. DAVIS
Attorney for Appellant, pro se

August 1988

(9)

No. 87-1020

IN THE SUPREME COURT
OF THE UNITED STATES

October Term, 1988

PAUL S. DAVIS,

Appellant,

v.

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,

Appellees.

On Appeal From the
Michigan Court of Appeals

# BRIEF FOR APPELLEES

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## QUESTION PRESENTED

Does the Michigan Income Tax Act, which provides a complete exemption for income from Michigan Public Retirement Systems but provides only a partial exemption for most federal retirement benefits, violate 4 USC § 111?

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**TABLE OF AUTHORITIES**

## Statutes







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## STATUTES INVOLVED

Federal

4 USC § 111:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

5 USC § 2105:

> (a) For the purpose of this title, "employee," except as otherwise provided by this section or when specifically modified, means an officer and an individual who is -- (1) appointed in the civil service by one of the following acting in an official capacity.
>
> (A) the President;
>
> (B) a Member or Members of Congress, or the Congress;
>
> (C) a member of a uniformed service;
>
> (D) an individual who is an employee under this section;

(E) the head of a Government controlled corporation; or

(F) the adjutant general designated by the Secretary concerned under section 709(c) of title 32;

(2) engaged in the performance of Federal function under authority of law or an Executive act; and

(3) subject to the supervision of an individual named by paragraph (1) of this subsection while engaged in the performance of the duties of his position.

***

5 USC § 8331(1)(A):
[Civil Service Retirement]

For the purposes of this subsection "employee" means an employee as defined by section 2105 of this title;

5 USC § 8331(9):
[Civil Service Retirement]

For the purposes of this subsection "annuitant" means a former employee or Member who, on the basis of his service, meets all requirements of this subchapter for title to an annuity and files claim therefor.



26 USC § 3401(c):
[Internal Revenue Code]

For purposes of this chapter, the term "employee" includes an officer, employee or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. The term "employee" also includes an officer of a corporation.

Michigan

MCL 206.8(2):
[Income Tax Act]

"Employee" means an employee as defined in section 3401(c) of the internal revenue code. Any person from whom an employer is required to withhold for federal income tax purposes shall prima facie be deemed an employee.

MCL 206.30(1)(g), (h):
[Income Tax Act]

"Taxable income" in the case of a person other than a corporation, an estate, or trust means adjusted gross income as defined in the internal revenue code subject to the following adjustments:

***

(g) Deduct, to the extent included in federal adjusted gross income, compensation, including retirement benefits, received for services in the armed forces of the United States.

(h) Deduct, to the extent included in adjusted gross income:

(i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.

(ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.

(iii) Social security benefits as defined in section 86 of the internal revenue code.

(iv) Retirement or pension benefits from any other retirement or pension system as follows:

(A) For a single return, the sum of not more than $7,500.00.

(B) For a joint return, the sum of not more than $10,000.00.

[NOTE: In 1987 Public Act 254 this Act was amended and this subsection was redesignated with no change in substance. For convenience we will use the designations as they have been referred to throughout this litigation.]



Michigan Administrative Code of 1979, Rule 206.2:

(1) The term "employee" is defined in section 8(2) of Act No. 281 of the Public Acts of 1967, as amended, being § 206.8(2) of the Michigan Compiled Laws.

(2) The term "employee" includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee. The term includes officers and employees, whether elected or appointed, of the United States, a state, territory, Puerto Rico, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any 1 or more of the foregoing.

(3) Generally, the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished; that is, an employee is subject to the will and control of the employer, not only as to what shall be done, but also as to how it shall be done. However, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also

an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work but not as to the means and methods for accomplishing the result, he is not an employee.

(4) Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are not employees.

(5) Whether the relationship of employer and employee exists shall, in doubtful cases, be determined upon an examination of the particular facts of each case.

(6) If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. For example, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.



(7) All classes or grades of employees are included within the relationship of employer and employee. Thus, superintendents, managers, and other supervisory personnel are employees. Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services, or performs only minor services, and who neither receives nor is entitled to receive, directly or indirectly, any remuneration, is not considered to be an employee of the corporation. A director of a corporation in his capacity as a director is not an employee of the corporation.

(8) The term "employee" includes every individual who receives a supplemental unemployment compensation benefit, which is treated as wages.

## STATEMENT OF THE CASE

Appellee State of Michigan accepts the statement of the case contained in the briefs of Appellant Davis and Amicus Curiae United States.

## SUMMARY OF ARGUMENT

The Michigan Income Tax Act provides a complete exemption for Michigan Public Retirement benefits, but only a partial exemption for other retirement benefits, including federal retirement benefits. In 4 USC § 111 the United States consents to taxation for compensation of federal employees, if the taxation does not discriminate against the employees because of the source of the compensation. The Michigan Income Tax Act does not violate 4 USC § 111 because Appellant Davis is a retiree, not an employee; because the discrimination which the

statute prohibits is discrimination against the government, not individuals; and because any discrimination which occurs is permissible because substantial differences exist between federal and state retirement benefits and the Michigan statutes are rationally related to the legitimate public purpose of fostering Michigan public employment.

The legislative history of 4 USC § 111 shows that Congress intended to permit federal employees to assert only those constitutional and statutory rights to which they, as individuals, were entitled. Congress did not intend that individuals could assert rights under the constitutional doctrine of intergovernmental tax immunity. 4 USC § 111 protects only the government itself under that constitutional doctrine and only to



the extent that state taxation is aimed at, or threatens the efficient operation of, the government itself. There is nothing in the record of this case to show that the Michigan Income Tax Act is aimed at the federal government, threatens the efficient operation of the federal government or, indeed, has any detrimental impact of any kind on the federal government.

The constitutional doctrine of intergovernmental tax immunity, as explained in Graves v New York, ex rel O'Keefe, 306 US 466 (1939), and other cases, is based on the Supremacy Clause and protects only governments--not individuals--from taxation efforts of other governments. Even though a government employee suffers adverse effects and some burdens are passed on to

the government itself, it cannot be assumed that the constitutional doctrine is violated, since some burdens are too speculative and other burdens are presupposed by the Constitution as the normal incidence of intergovernmental relations. The constitutional doctrine is violated only when the actual burdens are so severe as to be tantamount to an interference in the performance of governmental functions. There is nothing in the record of this case to show that the Michigan income tax imposes that type of burden on the federal government.

If the Court should conclude that the Michigan Income Tax Act violates federal rights, the appropriate remedy would be to award Appellant Davis the refund he seeks and then vacate the Michigan Court of Appeals judgment and remand to the



state courts with a mandate of equal treatment. The Michigan courts or the Michigan legislature could then determine whether to expand the tax exemption to those whose rights were violated by underinclusion or to nullify the exemption for those who currently enjoy it. Alternatively, if this Court imposes a remedy, it should extend the exemption rather than nullify it.

## ARGUMENT

## I

**THE MICHIGAN INCOME TAX ACT WHICH PROVIDES A COMPLETE EXEMPTION FOR INCOME FROM MICHIGAN PUBLIC RETIREMENT SYSTEMS BUT PROVIDES ONLY A PARTIAL EXEMPTION FOR MOST FEDERAL RETIREMENT BENEFITS DOES NOT VIOLATE 4 USC § 111.**

**A. The Constitutional Doctrine Of Intergovernmental Tax Immunity May Not Be Asserted By An Individual Federal Employee Or Retiree To Challenge A State Income Tax.**

1. The Arguments Of Appellant Davis And The Amici Curiae Improperly Attempt To Intermix The Statutory Interpretation Of 4 USC § 111 And The Principles Of The Constitutional Doctrine Of Intergovernmental Tax Immunity.

Much of the argument of Appellant Davis and both amici curiae concerns the doctrine of intergovernmental tax immunity. This doctrine, which is based on the Supremacy Clause, was first enunciated in McCulloch v Maryland, 4 Wheat 316 (1819), and has been discussed



and modified in many later cases including most recently South Carolina v Baker, 485 US ___, 99 L Ed 2d 592 (1988), which contains a summary of the history of the doctrine. Appellee State of Michigan asserts that the constitutional doctrine is irrelevant here because Graves v New York, ex rel O'Keefe, 306 US 466 (1939), holds that the doctrine is inapplicable to an income tax imposed by a state on federal employees and retirees and because the congressional history of 4 USC § 111 shows that Congress did not intend to codify the entire pre-existing constitutional doctrine, but only provided statutory protection for the federal government itself, not for employees.

Appellant Davis relies principally upon a statutory interpretation argument,

but in the course of doing so, attempts to use principles of the constitutional doctrine. The United States as amicus curiae asserts that the statute "restates ... the general constitutional rule" (brief, p 7) and although never categorically asserting that 4 USC § 111 <u>must</u> be interpreted the same as the constitutional doctrine, somewhat disingenuously says that "<u>If</u> construed the same way as the nondiscrimination principle derived from the doctrine of intergovernmental tax immunity, § 111 precludes" the Michigan statutory system here at issue (brief, p 6, emphasis added). The amicus curiae National Association of Retired Federal Employees (NARFE) recognizes a clear distinction between the interpretation of the statute and the constitutional doctrine, but



while relying principally on a statutory interpretation argument, completely ignores both the existence and ramifications of <u>Graves</u> in its constitutional argument. Appellee State of Michigan submits that Appellant Davis and both of the amici curiae fail to fully acknowledge the holding in <u>Graves</u> and give far too broad an interpretation to 4 USC § 111.

2. <u>Graves</u> v <u>New</u> <u>York</u>, <u>ex</u> <u>rel</u> <u>O'Keefe</u> <u>Holds</u> <u>That</u> <u>The</u> <u>Constitutional</u> Doctrine Of Intergovernmental Tax Immunity Cannot Be Asserted By An Individual Federal Employee Or Retiree To Challenge A State Income Tax.

In <u>Graves</u>, <u>supra</u>, this Court examined the constitutionality of an income tax imposed by the State of New York on the salary of an attorney employed by a federal instrumentality and concluded that such an income tax did not place an

unconstitutional burden on the federal government. In reaching that conclusion the Court discussed the principles underlying the doctrine of intergovernmental tax immunity and concluded that the only legitimate purpose of the doctrine was to protect the unique governmental functions of both the state and federal governments, 306 US at 477-478:

> "The theory of the tax immunity of either government, state or national, and its instrumentalities, from taxation by the other, has been rested upon an implied limitation on the taxing power of each, such as to forestall undue interference, through the exercise of that power, with the governmental activities of the other."

The Court observed that the constitutional doctrine of intergovernmental tax immunity must be "narrowly restricted", particularly where that immunity is



invoked by a private citizen, Graves, supra, 306 US at 483-484:

> " ... as applied to the taxation of salaries of the employees of one government, the purpose of the immunity was not to confer benefits on the employees by relieving them from contributing their share of the financial support of the other government, whose benefits they enjoy, or to give an advantage to that government by enabling it to engage employees at salaries lower than those paid for like services by other employers, public or private, but to prevent undue interference with the one government by imposing on it the tax burdens of the other." [Footnote omitted]

The Court emphasized that the constitutional doctrine protected the governments as entities, not the employees, 306 US at 480-481:

> "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable, [citations omitted] and the only possible basis for implying a constitutional immunity from state income tax of the salary of an employee of the national government or of a governmental agency is that the economic burden of the tax is in

> some way passed on so as to impose a burden on the national government tantamount to an interference by one government with the other in the performance of its functions."

In Graves, supra, an argument was made that the economic burden of an income tax on the employee did in fact fall on the employer, but the court rejected this contention as "speculative in character and measurement and too unsubstantial to form the basis of an implied constitutional immunity from taxation." 306 US at 485. The Court discussed an earlier opinion, Helvering v Gerhardt, 304 US 405 (1938), which upheld a federal income tax on the employees of a state agency, and concluded that the tax was not a burden on the agency itself. The Graves court applied the principles of Gerhardt and categorically rejected the argument that an income tax



on an employee can be assumed to impose a burden on the governmental employer. The Court even observed that even though a tax upon the income of employees of a government may result in some burden being passed on to the governmental employer through effects on the price levels of labor or materials, the constitutional doctrine is not necessarily implicated, Graves, supra, 306 US at 487:

> "[That burden] is but the normal incident of the organization within the same territory of two governments, each possessing the taxing power. The burden, so far as it can be said to exist or to affect the government in any indirect or incidental way, is one which the constitution presupposes ... ."

The Court refused to permit the employee taxpayer to assert the governmental employer's constitutional immunity, 306 US at 486:

> "In no case is there basis for the assumption that any such tangible or certain economic benefit is imposed

> on the government concerned as would justify a court's declaring that the taxpayer is clothed with the implied constitutional tax immunity of the government by which he is employed."

In conclusion, the Court rejected earlier cases which permitted governmental employees to assert the constitutional doctrine of intergovernmental tax immunity and overruled them, " ... so far as they recognize an implied constitutional immunity from income taxation of the salaries of officers or employees of the national or a state government or their instrumentalities." Graves, supra, 306 US at 486.

It should be noted that on pages 1-2 of its brief, amicus curiae United States asserts that the Michigan taxation system harms the United States in two ways, but these are precisely the type of arguments which were rejected in Graves as being



too speculative and unsubstantial to permit a federal employee to assert constitutional immunity from taxation. The United States asserts that it is put to a competitive disadvantage in hiring qualified employees because pension benefits of federal retirees would have to be raised in order to attract qualified employees if pension benefits were taxed by Michigan. It also contends that the state's tax scheme forces the United States to subsidize the pension of state retirees through a lower federal tax. Appellee State of Michigan submits that these assertions are not only speculative and unsubstantial, but also wrong.

Pensions of federal retirees are set by statute, 5 USC § 8331 et seq, and as argued infra, pages 51-57, they are more

generous than analogous Michigan benefits. There has been no evidence presented that would indicate that Congress would choose to alter the present federal retirement payments because those payments in excess of $7,500 per year are subject to Michigan income tax. The United States asserts that it loses tax receipts because if the retirement benefits of former state employees were taxed as the benefits of former federal employees are, the State of Michigan would increase state pensions to offset that tax, thus increasing federal tax revenues. This argument is speculative because there is no assurance that Michigan would increase pensions even if they were subject to state tax, and it is wrong because it fails to recognize that state income tax would be claimed as an



itemized deduction, thus lowering federal tax revenues.

These speculative arguments by the United States are insufficient to permit application of the constitutional doctrine of intergovernmental tax immunity to an individual taxpayer such as Appellant Davis.

3. Other Cases Which Define The Modern Doctrine Of Intergovernmental Tax Immunity Do Not Permit An Individual Federal Employee Or Retiree To Assert The Doctrine To Challenge A State Income Tax On The Ground That It Discriminates Against The Individual.

<u>Graves</u>, <u>supra</u>, enunciated the constitutional theory upon which the modern doctrine of intergovernmental tax immunity is based. The fundamental principle is that the doctrine protects only governments, not individuals. The doctrine does not protect governments

against all burdens, since there are many negative effects which are "but the normal incidents" "which the constitution presupposes", 306 US at 487, but it protects governments only against those burdens which are "tantamount to an interference by one government with the other in the performance of its functions.", 306 US at 481. Furthermore, the existence of such an impermissible burden must be demonstrated; it cannot merely be assumed to exist. As is demonstrated elsewhere in this brief (<u>infra</u>, pages 25-57) Appellees submit that the congressional history of 4 USC § 111 shows that congressional intent was fully consistent with these principles enunciated in <u>Graves</u>.

Appellant Davis and the amici cite several cases including <u>Phillips Chemical</u>



<u>Co</u> v <u>Dumas Independent School District</u>, 361 US 376 (1960), <u>Moses Lake Homes</u> v <u>Grant County</u>, 365 US 744 (1961), and <u>Memphis Bank & Trust Co</u> v <u>Garner</u>, 459 US 392 (1983), for the principle that <u>any</u> discrimination by a state statute against a federal employee or retiree triggers the constitutional doctrine of inter-governmental tax immunity and renders the state statute invalid. Appellee State of Michigan submits, however, that those cases do not support such an expansive interpretation of the constitutional doctrine and do not compel the result which Appellant Davis seeks.

Initially it must be observed that those cases are factually distinguishable from the instant situation because, unlike the instant case, they involve commercial or economic relationships

between the federal government and third parties rather than an employer-employee relationship and the application of a state income tax, which was precisely the situation which existed in Graves, supra. Furthermore, in the instant case there is absolutely nothing in the record to demonstrate that the federal government suffers any economic burden or any effects whatsoever from the alleged discrimination while in Phillips and Moses Lake the court specifically concluded that the state practices discriminated against the United States and its lessees. Phillips, supra, 361 US at 387; Moses Lake Homes, supra, 365 US at 751. Memphis Bank & Trust Co also concluded that the economic incidence of a state tax fell on the federal government and that the state tax discriminated



against federal obligations. 459 US at 397.

More important than any factually distinguishing characteristics, however, is the proper application of the constitutional principle of intergovernmental tax immunity. Appellant Davis cites those cases for the proposition that the constitutional doctrine prohibits any discrimination "against the United States or those with whom it deals". Appellant's brief, page 26. Appellee State of Michigan submits that while there is broad language to that effect in the opinions, it must be applied with caution in the instant case for at least two reasons.

First, the language cannot be applied literally since the pragmatic consequences of such an interpretation would

be intolerable. The modern constitutional doctrine requires examination of all of the circumstances surrounding tax statutes alleged to be unconstitutional as the Court said in United States v Detroit, 355 US 466, 469 (1958):

> "Of course in determining whether a tax is actually laid on the United States or its property this Court goes beyond the bare face of the taxing statute to consider all relevant circumstances."

Similarly in Phillips Chemical Co, supra, 361 US at 383, the Court recognized that individual tax statutes do not "operate in a vacuum" and a determination of their constitutionality requires "an examination of the whole tax structure of the state." In this era of extensive economic contacts between governments and private individuals and enterprises, the number of entities "with whom [the government]



deals" is vast indeed. Although Appellant Davis does not argue that a retiree from General Motors, for example, is entitled to assert the constitutional doctrine of intergovernmental tax immunity, can it be doubted that such a retiree would soon make that argument if the doctrine is given the broad scope asserted in the instant case?

The second reason why the doctrine should not be given such a broad scope is related to these pragmatic considerations: the rationale of Graves would surely be violated by such an expansive application of the doctrine. The thrust of the evolution of the modern doctrine, as described in South Carolina v Baker, supra, 485 US ___, shows a clear trend toward a recognition of legal and economic realities. Appellee State of

Michigan submits that a doctrine based on the Supremacy Clause and the principle of protecting only governments in the performance of their governmental functions cannot be invoked by every individual with whom a government deals.

In summary, there is nothing in this record to demonstrate that the federal government suffers any economic burden or any detrimental impact from the alleged discrimination caused by the Michigan Income Tax Act. Under the principles espoused in Graves, it can only be concluded that an individual such as Appellant Davis cannot invoke the doctrine for his own benefit in these circumstances.



**B. The Legislative History Of 4 USC § 111 Does Not Indicate That Congress Intended To Codify The Entire Pre-existing Constitutional Doctrine Of Intergovernmental Tax Immunity.**

If the constitutional doctrine does not apply, then the issue in the instant case becomes merely one of statutory interpretation. Before making such a statutory interpretation analysis, however, it must be determined whether 4 USC § 111 codifies the constitutional principle, since if it does, the statutory interpretation analysis will be governed by the constitutional principles. See Memphis Bank & Trust Co v Garner, 459 US 392, 396-397 (1983), where the Court interpreted 31 USC § 742 to determine whether a tax was "nondiscriminatory", but the analysis was governed by the principles of the constitutional doctrine of intergovernmental

tax immunity since previous decisions of the Court had treated that statute as "principally a restatement of the constitutional rule." In the instant case Appellee State of Michigan submits that the legislative history indicates that 4 USC § 111 was not intended to codify the constitutional doctrine with respect to individuals such as Appellant Davis and therefore the principles applicable to the constitutional doctrine do not govern the statutory analysis.

Because the principles governing the taxation of governmental employees were undergoing a judicial and congressional upheaval in the late 1930s, it is important to recall the chronology of events of that time. The doctrine of intergovernmental immunity was first recognized in McCulloch v Maryland,



supra, and is not explicitly stated directly in the constitution but is based upon the Supremacy Clause. For decades the doctrine was broadly construed to provide, among other things, that it was unconstitutional for the federal government to impose an income tax on a state employee and for a state government to impose an income tax on a federal employee. The history of the doctrine is summarized in South Carolina v Baker, 99 L Ed 2d at 604-610, and the court stated the rationale for this broad interpretation during the early years of the doctrine, South Carolina v Baker, supra, 99 L Ed 2d at 606:

> "This general rule was based on the rationale that any tax on income a party received under a contract with the government was a tax on the contract and thus a tax 'on' the government because it burdened the government's power to enter into the contract."

In later years, however, this theory was rejected, South Carolina v Baker, supra, 99 L Ed at 607-608:

> "The rationale underlying Pollock and the general immunity for government contract income has been thoroughly repudiated by modern intergovernmental immunity caselaw."

This modern theory is exemplified by Graves v New York, ex rel O'Keefe, supra.

As this change was evolving in a series of cases throughout the 1930s, there were parallel stirrings in the executive and legislative branches of government. For example, Helvering v Gerhardt, supra, 304 US 405, was argued on April 7 and 8, 1938 and decided May 23, 1938. In that short interim period, President Roosevelt sent a message to Congress dated April 25, 1938, emphasizing the need for legislation relating to the taxation of the compen-



sation of public officers and employees. A similar message was sent from the President to the Congress dated January 19, 1939, which, as reported in the Senate's report from the Committee on Finance on the Public Salary Tax Act of 1939, S. Rep. 112, 76th Cong., 1st Sess. (1939), emphasized the need for the legislation, pointed out the equity involved in subjecting the future salaries of government employees to the income tax laws of the nation and of the several states, and "drew attention to the requirement of immediate legislation to prevent recent judicial decisions from operating in such a retroactive fashion as to impose tax liability for past years ... ." That Senate report was issued February 24, 1939, and closely followed the House of Representatives report from

the Committee on Ways and Means, H. R. Rep. 26, 76th Cong., 1st Sess. (1939), dated February 7, 1939. In March, 1939, the month after the congressional reports were issued, the Graves case was argued and decided by this Court, and the Public Salary Tax Act of 1939, chapter 59, 53 Stat. 575, was passed by Congress and became law the next month, April, 1939.

At the time these congressional committee reports were issued, Graves had not yet been decided, and so Congress was operating under the assumption that, while the contours of the doctrine were in flux, the implied constitutional basis of the doctrine required the consent of the United States before the compensation of federal officers and employees could be taxed by the states. The House report said, at page 2:



> "Your committee believes that it is essential to a fair solution of the problem presented by intergovernmental tax immunities that Federal officers and employees should, like other individuals, be subject to income taxation under the authority of the States."

The Senate report was even more explicit in its recognition that, while there might be constitutional problems involved in the proposal to include state salaries in a federal income tax, "there is no corresponding problem with respect to the state taxation of the salaries paid to federal officers and employees, since congress apparently has power to waive any immunity which might attach to its employees." Senate report, supra, page 4. The Senate report goes into considerable detail in its discussion of the cases which were resulting in the evolution of the modern doctrine of

intergovernmental tax immunity, and even quoted from Gerhardt, supra. See Senate report, supra, page 9. Even the amicus curiae brief of the United States recognizes that this statutory section, "was designed to waive federal immunity to permit such taxation." (Brief of the United States as amicus curiae, page 8).

Because of its citation of the principles enunciated in cases such as Gerhardt, supra, and because of the explicit statements that the bill was intended to waive any constitutional immunity from state taxation, it is beyond doubt that, at least with respect to income taxation of individuals, 4 USC § 111 is not a codification of the constitutional principle of intergovernmental tax immunity.

It must be borne in mind, however,



that § 111 contains two aspects; the first portion of the statute contains a consent by the United States to taxation of compensation of federal officers and employees, and the latter portion of the statute contains an exception which withholds consent if the taxation discriminates against the officer or employee because of the source of the compensation. The legislative history shows an express waiver of any constitutional intergovernmental tax immunity which might have been asserted by individual employees while preserving their right to raise other individual objections, but also indicates that Congress did intend to preserve, in the latter part of the statute, the constitutional intergovernmental tax immunity of the United States itself. The congressional

intent with respect to the general grant of consent to taxation of individuals while retaining a limited exception protecting the government is contained in both the House report, supra, pages 4-5, and the Senate report, pages 11-12:

> "In order to facilitate reciprocal taxation as between State and Federal Governments, your committee believes that the United States should expressly consent to the taxation of the compensation of its officers and employees. * * *
>
> "The consent is not intended to operate, nor could it operate, as a consent to any taxation to which as individuals these officers and employees are entitled to object either under the provisions of the Federal Constitution or of the constitutions or statutes of the respective States. For example, the consent has no effect upon the rights of an officer of the Federal Government to object that the imposition of a State tax upon him is invalid under the fourteenth amendment. Thus he may urge that a particular tax is invalid as to him because of an unreasonable classification, or the lack of geographical jurisdiction to tax, or for other reasons. Similarly, the consent has no effect upon the rights which such



> officers and employees possess as individuals under the various State constitutions and laws. To protect the Federal Government against the unlikely possibility of State and local taxation of compensation of Federal officers and employees which is aimed at, or threatens the efficient operation of, the Federal Government, the consent is expressly confined to taxation which does not discriminate against such officers or employees because of the source of their compensation. * * * ." [Emphasis added]

This language from the committee reports shows a congressional intent remarkably similar to the rationale which the Supreme Court enunciated the next month in the Graves opinion. Congress clearly intended to waive any constitutional intergovernmental tax immunity which might apply to individual federal employees, while preserving the right of those officers and employees as individuals to assert their own constitutional rights, such as objecting to a particular

tax because of an unreasonable classification under the Fourteenth Amendment. The statutory consent to taxation contained an exception for taxation which discriminates against the employees because of the source of the compensation and the congressional reports clearly demonstrate that this provision was intended to protect the federal government -- not the individual employee -- "against the unlikely possibility of state and local taxation of compensation of Federal officers and employees which is aimed at, or threatens the efficient operation of, the Federal Government ... ."

This expression of congressional intent dovetails very neatly with the rationale of Graves which, in summary, provides that the constitutional doctrine



of intergovernmental tax immunity cannot be employed to protect individuals as individuals, but only serves to protect the functions of a government itself from impermissible interference by the taxation efforts of another government. There is nothing in the language of 4 USC § 111, the legislative history, or decisions of this Court which indicates any congressional intent to permit an individual employee, such as Appellant Davis, to utilize the statute to assert on his own behalf the constitutional doctrine of intergovernmental tax immunity from Michigan's taxation efforts.

It must be recalled, of course, that Congress is free to enact the type of immunity statute which Appellant Davis seeks at any time, as the Court observed

in South Carolina v Baker, supra, 99 L Ed 2d at 607, n. 10:

> "The Federal Government, for example, possesses the power to enact statutes immunizing those with whom it deals from state taxation even if intergovernmental tax immunity doctrine would not otherwise confer an immunity."

**C. The Michigan Income Tax Act Does Not Violate 4 USC § 111 With Respect To Appellant Davis Because The Federal Act Does Not Apply To Him Or, Alternatively, Any Discrimination Of Which He Is Entitled To Complain Is Justified By The Substantial Differences Between Federal Retirement Benefits And State Retirement Benefits.**

1. Appellant Davis Is Not An Officer Or Employee Within The Meaning Of 4 USC § 111.

In 4 USC § 111 the United States consented to the taxation of "pay or compensation for personal service as an officer or employee ... if the taxation does not discriminate against the officer or employee because of the source of the



pay or compensation." Appellant Davis does not contend that he is an officer, but he does contend that he is an "employee" for the purposes of the section. The Michigan courts carefully considered this claim and rejected it. J.S. App. A4-A6. For federal civil service purposes an "employee" is defined at 5 USC § 8331(1)(A) and 5 USC § 2105. Clearly, Appellant Davis is not a current employee since he is no longer "engaged in the performance of a federal function". The Michigan courts correctly characterized his status as that of an annuitant which is defined in 5 USC § 8331(9) as a former employee. The word "employee" has been judicially interpreted to encompass only those who currently work for another for hire. See Allied Chemical & Alkali Workers of

America v Pittsburgh Plate Glass Co, 404 US 157 (1971); Lancellotti v Office of Personnel Management, 704 F2d 91, 95 (CA 3, 1983).

That federal definition of "employee" is consistent with the definition for Michigan income tax purposes contained in MCL 206.8 (which incorporates the internal revenue code definitions in 26 USC § 3401(c)) and in Michigan Administrative Code 1979, Rule 206.2, which provides that a relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the service, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. In other words, an



employee is subject to the will and control of the employer, not only as to what shall be done, but also as to how it shall be done. In addition, the employer possesses the right to discharge the employee.

Appellant Davis and the amici curiae acknowledge the validity of these definitions of "employee" and do not contend that Davis is presently an employee, but they assert that these definitions are irrelevant because the first portion of 4 USC § 111 refers not just to compensation "of" an employee, but compensation for personal services "as" an employee. They then point to cases which refer to retirement benefits as deferred compensation. See Appellant's Brief, pages 15-17. This argument omits reference to the latter

portion of the statute which does not contain the language Appellant relies on and clearly contemplates current status as an employee (" ... if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation"). In addition, the legislative history of the statute does not support Appellant's argument. In the House and Senate committee reports, no distinction is made between taxation "of" the compensation of employees and taxation of compensation for personal service "as" an employee. The following language is contained in both the House report, _supra_, at page 4 and the Senate report, _supra_, at page 11:

> "In order to facilitate reciprocal taxation as between State and Federal Governments, your committee believes that the United States should _expressly consent to the taxation of the compensation_ of its officers and employees. Section 3 of the bill



> therefore provides that the United States consents to the taxation of compensation received after December 31, 1938, for personal service as an officer or employee of the United States... ." [Emphasis added]

Appellant Davis is not currently an employee and therefore Appellee State of Michigan submits that he is not within the scope of any protection afforded by 4 USC § 111.

2. 4 USC § 111 Prohibits Discrimination Against Governments, Not Individual Employees.

As we have previously argued, (_supra_, pages 9-38) both the congressional history of 4 USC § 111 and this Court's rationale in _Graves_, _supra_, reveal that only governmental entities _as entities_ are protected by the constitutional doctrine of intergovernmental tax immunity and by the language of 4 USC

§ 111 which prohibits discrimination against employees because of the source of their compensation. Both the House and Senate reports clearly indicated that the statutory language was only intended for a limited purpose:

> "To protect the Federal Government against the unlikely possibility of State and local taxation of Federal officers and employees which is aimed at, or threatens the efficient operation of, the Federal Government . . . ."

Likewise, the rationale of <u>Graves</u>, <u>supra</u>, indicates that the constitutional doctrine was not intended to protect employees, but only to protect governments themselves, <u>Graves</u>, <u>supra</u>, 306 US at 483-484:

> "As applied to the taxation of salaries of the employees of one government, the purpose of the immunity was not to confer benefits on the employees by relieving them from contributing their share of the financial support of the other government, whose benefits they enjoy, or to give an advantage to that government by enabling it to engage employees at salaries lower than those paid for like services by other employers, public or private, but to prevent undue interference with the one government by imposing on it the tax burdens of the other." [Footnote omitted]



In the instant case if there is discrimination in the effects of the Michigan Income Tax Act, the discrimination applies only to Appellant Davis and has no impermissible impact upon the federal government. <u>Graves</u> recognized that the constitutional immunity must be "narrowly restricted" 306 US at 483, and stated that the immunity cannot simply be implied, because even though some of the burden on an employee may be passed on to his or her governmental employer, any such burden, "is but the normal incident of the organization within the same territory of two governments, each

possessing the taxing power. The burden ... is one which the constitution presupposes ... ."

Although Graves, supra, dealt with questions of economic burden and the instant case deals with a question of discrimination, the court's discussion of the rationale for the constitutional doctrine of intergovernmental tax immunity remains the same in both instances. In Graves the Court held that even though an employee suffered an economic burden by state taxation, the constitutional doctrine did not permit imputing that burden to the federal government employer by implication. Here, Appellant Davis alleges that he suffers discrimination, but Appellee State of Michigan submits that the Graves rationale prohibits imputing any effect



of such discrimination to the government employer by implication. In the instant case there is nothing in the record to demonstrate "undue interference with the one government by imposing on it the tax burdens of the other" (Graves, supra, 306 US at 484) or to demonstrate that the Michigan Income Tax Act "is aimed at or threatens the efficient operation of, the federal government" (House report, supra, page 5; Senate report, supra, page 12).

In summary Appellee State of Michigan submits that neither the constitutional doctrine of intergovernmental tax immunity nor the statutory protections of 4 USC § 111 protect Appellant Davis as an individual from the burdens of the Michigan Income Tax Act. The constitutional doctrine cannot be implied and so Appellant Davis bears the burden of

demonstrating by facts in the record that the Michigan Income Tax Act is aimed at or threatens the efficient operation of the federal government or that the consequences as to him are so severe as to result in undue interference with the federal government. There are no facts in this record to demonstrate such effects and the allegations of potential harm to the United States contained on pages 1-2 of the amicus curiae brief of the United States are, just as they were in Graves, supra, 306 US at 485, too "speculative in character and measurement and too unsubstantial to form the basis of an implied constitutional immunity from taxation."



3. Even If Appellant Davis Is Entitled To Complain Of Discrimination In This Case, It Is Justified By The Substantial Differences Between Federal Retirement Systems And Public Retirement Systems In Michigan.

It is undisputed that benefits received from Michigan public retirement systems enjoy a tax exemption which is not available to most other retirement benefits, including benefits from federal retirees such as Appellant Davis. The Michigan courts analyzed this difference in treatment under traditional equal protection principles in order to determine whether the distinctions "bear a rational relationship to a legitimate state end", Jurisdictional Statement App. A6-A7. A similar traditional equal protection analysis was used in Grauvogel v Commissioner of Internal Revenue, 768 F2d 1087 (CA 9, 1985), where the court

upheld a federal statute granting tax-free status to a cost-of-living allowance given only to federal employees working in Alaska where Alaskan state employees were not given similar tax-free status. Appellee State of Michigan submits that this is the appropriate analytical standard to be employed in this case.

Appellant Davis and the amici curiae which support him, however, assert that the constitutional doctrine of intergovernmental tax immunity is implicated and that therefore a more difficult standard must be met in order to justify the distinctions. In Phillips Chemical Co v Dumas Independent School District, 361 US 376, 383 (1960), this Court said that if the constitutional doctrine is applicable, distinctions "must be



justified by significant differences between the two classes."

In the instant case Appellee State of Michigan submits that the "rational relationship to a legitimate state end" test rather than the "significant differences" test should be employed because the constitutional doctrine of intergovernmental tax immunity is not applicable, but in any event, Michigan submits that there are significant differences between the Michigan public retirement systems and the federal retirement systems which justify the different tax treatment under either standard.

The Michigan Court of Appeals concluded that "the attracting and retaining of qualified employees is a legitimate state objective which is rationally achieved by a retirement plan

offering economic inducements." J. S. App. A7. Neither Appellant Davis nor the amici curiae which support him appear to dispute this conclusion. Thus, if a traditional equal protection analysis is employed, the distinction between Michigan public employment retirement system benefits and all other retirement benefits (including federal retirement benefits) is legitimate and constitutional.

In addition to that justification, however, there are significant differences between federal retirement benefits and Michigan public employment retirement benefits which support different treatment.[1] Federal retirement benefits are significantly more generous

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[1]It should be noted that since Appellant Davis retired there have been changes to both the federal retirement system, see 5 USC § 8401 et seq, and to the Michigan public employment systems



than Michigan public employment retirement benefits in several respects. First, in order for a state employee to have a pension "vested", ten years of service is required, MCL 38.19, as opposed to five years of service for federal retirees, 5 USC § 8333. Second, the amount of pension benefits is based upon average final compensation and during the times at issue, Michigan public employment retirement benefits

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(such as a 1987 change from using five years to using three years for determining final average compensation). In addition, there are differences between the retirement benefits of various groups of state and local retirees, depending on statutory provisions and collective bargaining agreements. The discussion in the text is based upon benefits available to retirees from the State's civil service system as of the date of Appellant Davis' retirement in 1980. This group most closely approximates Davis' situation.

required using a five-year average, MCL 38.1(r), while the federal retirement system utilized a three-year average, 5 USC § 8331. Third, the amount of pension benefits is dependent upon the multiplier which is applied to the average compensation (together with years of service) and for purposes of Michigan public employment retirement benefits a multiplier of 1.5% was used, MCL 38.20(1), while for federal retirement purposes a sliding scale of 1.5% to 2.5% was used, 5 USC § 8339. Fourth, federal retirees may have life insurance continued after retirement. This benefit is mandated by statute in the same amount as before retirement. The amount of life insurance is then gradually reduced to either 50% or 25% of its face value depending on the retiree's election, 5



USC § 8706. State retirees, on the other hand, may have life insurance continued at a benefit of 25% of the amount held immediately prior to the retirement date. This benefit is not guaranteed by statute, but merely provided by contract.

When viewed in their entirety, it is clear that there are substantial differences between the retirement systems of federal employees and Michigan public employees. The federal system is much more rewarding financially and the federal benefits are much more secure than the benefits provided by the state system. To the extent that Michigan public employment systems are in competition with the federal government in seeking to hire and retain competent employees, Michigan public employment systems are at a significant disadvantage

when their retirement benefits are compared with federal retirement benefits.

This favorable treatment enjoyed by federal retirees is not a new development in the law. Even when the predecessor to 4 USC § 111 was in the process of enactment, it was recognized that federal employees enjoyed benefits greater than those of state and local government employees. In the Senate report from the Committee on Finance on the Public Salary Tax Act of 1939, supra, page 4, the committee discussed the economic impact of the proposed legislation and recognized that, on the average, federal salaries were generally higher than those paid by state and local governments:

> " ... Federal salaries in the low and middle salary range group are generally higher than those paid by State and local governments. It is believed that these employees should share in the cost of their State and local governments to the same extent as private employees."



The favorable treatment federal employees enjoy has continued from 1939 until the present day. The current substantial differences between federal retirement benefits and Michigan public employment retirement benefits are sufficient to justify the different tax treatment such benefits receive.

## II

**ASSUMING THAT THE MICHIGAN INCOME TAX EXEMPTIONS ARE IMPERMISSIBLY UNDER-INCLUSIVE, THIS COURT SHOULD VACATE THE STATE COURT DECISION AND REMAND TO THE STATE COURTS FOR DETERMINATION OF THE PROPER REMEDY OR, ALTERNATIVELY, THIS COURT SHOULD EXPAND THE EXEMPTION TO COVER FEDERAL RETIREES SUCH AS APPELLANT DAVIS RATHER THAN NULLIFY THE EXEMPTION CURRENTLY AVAILABLE TO OTHER PUBLIC EMPLOYMENT SYSTEM RETIREES.**

The Michigan Income Tax Act exempts retirement benefits for retirees from the armed forces of the United States and exempts retirement benefits received from public retirement systems of state and local governmental units, but does not exempt the retirement benefits of all federal retirees such as Appellant Davis. If this failure to include the retirement benefits of all federal retirees in the exemption from Michigan income tax violates either 4 USC § 111 or the constitutional principle of intergovern-



mental tax immunity, the question arises as to the appropriate remedy, both as to Appellant Davis and, possibly, to other similarly situated federal retirees. In his complaint and amended complaint Appellant Davis requested the following relief:

> "(A) Judge, determine and decree that the Michigan Income Tax Law, insofar as it purports to tax income from Federal Civil Service Retirement benefits, is invalid and unconstitutional.
>
> "(B) Enter judgment for the plaintiff against the defendant in the sum of $4,299.53 being the amount of Michigan Income Taxes paid by plaintiff, based on Federal Retirement benefits, for the years 1979-1984, inclusive, together with interest." Joint App. 10-11.

As amicus curiae United States says in their brief, page 19, note 12, the proper prospective remedy in the circumstances of this case is a mandate of equal treatment which may be accomplished

either by extending the statutory exemption to all federal retirees or by invalidating the exemption as to all other governmental retirees who currently receive the favored treatment. There is nothing in the record of this case to show which of these alternatives the State of Michigan would prefer to adopt, so if this Court finds the current statutory plan unconstitutional, the Appellees submit that the most appropriate remedy would be to reverse the judgment of the Michigan Court of Appeals and declare that equality of treatment is mandated and then remand to the state courts for further proceedings, leaving it to the Michigan courts or the Michigan legislature to determine whether the discriminatory statutory exemption should be extended to Appellant and all



other federal retirees or withdrawn from all governmental retirees currently receiving the exemption.

**A. If Appellant Davis' Federal Rights Have Been Violated, The Appropriate Remedy Would Be To Award Him A Refund.**

Amicus curiae United States asserts, brief page 19, note 12, that with respect to Appellant Davis' claim for a refund, Michigan's "only option appears to be to give appellant a refund of any taxes he has paid on his federal pension" and cites Phillips Chemical Co v Dumas Independent School District, 361 US 376 (1960), and Moses Lake Homes, Inc v Grant County, 365 US 744 (1961), for the proposition that "a discriminatory tax is void and 'may not be exacted'". Unlike the instant case which seeks a refund and interest for taxes already paid, however,

neither Phillips nor Moses Lake Homes involved a request for a refund. Phillips was an action to enjoin collection of a tax and Moses Lake Homes began as a condemnation action and an injunction against proceeding with a tax sale. In both cases no taxes had been paid and only a prospective decree was sought to declare the taxes invalid. To say that a tax is invalid and may not be exacted in the future is not the same as saying that taxes which have already been paid must be refunded with interest. However, in Iowa-Des Moines National Bank v Bennett, 284 US 239 (1931), the Court did order a refund to a taxpayer who had been discriminated against in violation of federal law when it was taxed more heavily than its competitors. The Court observed that equality of treatment could



be achieved if the state either increased the competitors' taxes or decreased the petitioner's, but noted that petitioner should not be required to assume the burden of seeking an increase of the taxes which the others should have paid. 284 US at 247.

Michigan law permits refunds of taxes with interest, MCL 205.30, and so, consistent with Iowa-Des Moines National Bank, if the failure to include Davis' retirement benefits in the exemption from Michigan income tax violates his federal rights, it would be appropriate to award him the refund he seeks.

**B. If The Michigan Income Tax Act Violates The Federal Rights Of Others Who Are Similarly Situated, This Court Should Vacate The Michigan Judgment And Remand The Case To The State Courts For Further Proceedings.**

Even assuming this remedy is appropriate for Appellant Davis, however,

it is not necessarily appropriate for all others who may be similarly situated. Even in Iowa-Des Moines National Bank where the court recognized the inappropriateness of compelling the taxpayer to assume the burden of seeking an increase of the taxes of others, it also recognized that the federal right which is at issue is not a protection against overassessment of taxes; rather it is a right to equality of treatment, 284 US at 247:

> "The right invoked is that to equal treatment; and such treatment will be attained if either their competitors' taxes are increased or their own reduced."

This recognition of two remedial alternatives was articulated with particular clarity by Mr. Justice Harlan's opinion concurring in the result in Welsh v United States, 398 US 333,



344-367 (1970), where a majority of the Court reversed a conviction under the Universal Military Training and Service Act because of an underinclusive definition of what constituted a "religious" basis for conscientious objector status. The rationale of the plurality opinion of four Justices was that conscientious objector status could be given to the petitioner in Welsh by simple judicial construction of the language of the statute. Justice Harlan, however, believed that the plurality's opinion exceeded the limits of the doctrine of judicial construction of statutes and that it was therefore necessary to determine whether the statute's limitation of conscientious objector status to those whose beliefs were "religious" violated the First Amendment. He believed that

the statute was unconstitutionally underinclusive since it did not permit conscientious objector status based upon strongly held moral or ethical beliefs. The alternatives, then, were to declare the statute unconstitutional for failure to extend its benefits to non-religious beliefs or to extend the coverage of the statute to those who had been wrongfully excluded. It should be noted that Justice Harlan's opinion expressed only his own views, but the Court has subsequently cited the opinion favorably in both majority and unanimous opinions of the Court. See Califano v Westcott, 443 US 76, 89 (1979) and Heckler v Mathews, 465 US 728, 738-739 (1984). Appellees submit that the rationale expressed in Justice Harlan's opinion in Welsh is applicable to the instant case.



The core of Justice Harlan's rationale is found in this often-quoted paragraph, Welsh, supra, 398 US at 361:

> "Where a statute is defective because of underinclusion there exists two remedial alternatives: a court may either declare it a nullity and order that its benefits not extend to the class that the legislature intended to benefit, or it may extend the coverage of the statute to include those who are aggrieved by the exclusion."

Justice Harlan recognized that applying the benefits of a statute to a group not explicitly encompassed in the language of the statute involves something more than mere traditional judicial construction, Welsh, supra, 398 US at 355-356:

> "If an important congressional policy is to be perpetuated by recasting unconstitutional legislation, as the prevailing opinion has done here, the analytically sound approach is to accept responsibility for this decision. Its justification cannot be by resort to legislative intent, as that term is usually employed, but by a different kind of legislative intent, namely the presumed grant of power to the courts to decide whether it more

> nearly accords with Congress' wishes to eliminate its policy altogether or extend it in order to render what Congress plainly did intend, constitutional."

Before turning to an application of this principle in the instant case, it is important to recall that in Welsh the Court was interpreting a federal statute, and in the instant case, a state statute is involved. Justice Harlan extended the coverage of the federal statute in Welsh, albeit with some misgivings, but he also recognized " ... the more limited discretion this Court enjoys to extend a policy for the States even as a constitutional remedy." Welsh, supra, 398 US at 362, n. 15. Defendants-Appellees submit that in the instant case there are strong policy reasons why this Court should not embark on this analysis, but should instead vacate the judgment of the



Michigan Court of Appeals and remand this case to the state courts in order that the Michigan courts or the Michigan legislature be given an opportunity to determine whether the discriminatory statutory exemption should be extended to Appellant and other federal retirees or should be withdrawn from all other governmental retirees who currently receive the favored treatment.

In Skinner v Oklahoma, 316 US 535 (1942), the Court recognized the alternative course of extending a statute to cover an excluded class or not applying it to the wrongfully included group, but under the circumstances of that case, the Court declined to speculate which alternative the state would prefer to adopt and simply reversed the judgment. A similar result, in a less stark factual

context, was reached in Dorchy v Kansas, 264 US 286 (1924). In that case one section of a state labor statute was challenged on constitutional grounds but instead of reaching the merits of the constitutionality of the section, the Court chose to vacate the state court judgment and remand to the state courts to determine if the section had already been invalidated as a result of an earlier decision by this Court invalidating another portion of the same statute. In language appropriate to the instant case, the Court concluded that, in the absence of guidance from the state court, it was inappropriate to determine the question of severability, 264 US at 290-291:

> " *** Whether § 19 is so interwoven with the system held invalid that the section cannot stand alone, is a question of interpretation and of legislative intent. ***



> "The task of determining the intention of the state legislature in this respect, like the usual function of interpreting a state statute, rests primarily upon the state court. Its decision as to the severability of a provision is conclusive upon this Court. *** In cases coming from the state courts, this Court, in the absence of a controlling state decision, may, in passing upon the claim under the federal law, decide, also, the question of severability. But it is not obliged to do so. The situation may be such as to make it appropriate to leave the determination of the question to the state court. We think that course should be followed in this case.
>
> " *** So far as appears, the state court has not passed upon the question whether § 19, being an intimate part of the system of compulsory arbitration held to be invalid, falls with it. In order that the state court may pass upon this question, its judgment in this case, ... should be vacated."

In the instant case the Michigan statutory system provides exemptions for retirement benefits from public retirement systems within Michigan, from retirement benefits received from public

retirement systems of other states or political subdivisions which have reciprocity for similar Michigan benefits, and for retirement benefits received from the armed forces of the United States. This system dates at least since 1969 when the exemptions were enacted, and there is nothing in the record of this case in the way of legislative history or Michigan judicial authority to indicate how the state would interpret these provisions if their validity is called into question because the statutory system fails to exclude retirement benefits of other federal retirees. Given the fact that significant state revenues and policies are involved and given the fact that it is "necessary to measure the intensity of commitment to the residual policy and



consider the degree of potential disruption of the statutory scheme that would occur by extension as opposed to abrogation", Welsh, supra, 398 US at 365, Appellees submit that in the circumstances of this case, it would be most appropriate for this Court simply to vacate the judgment of the Michigan Court of Appeals and remand to the state courts with a mandate of equality of treatment, leaving it to the state courts or state legislature to determine whether the statutory exemption should be extended or withdrawn.

**C. If This Court Imposes A Remedy, It Should Extend The Michigan Tax Exemption To Those Whose Rights Are Violated Rather Than Nullifying The Exemption For Those Who Currently Receive It.**

Given the importance of these factors, Appellees submit that it is likely

that Michigan would choose to extend the benefits to federal retirees such as Appellant Davis, rather than withdrawing the benefits from all other governmental retirees and therefore, should this Court choose to reach the question itself instead of remanding to the state courts, Appellees submit that this Court should extend the statutory tax exemption rather than withdrawing it. There are several factors which militate in favor of this conclusion.

First, as shown by the history of the Michigan statutory system, the pattern is one of expanding, rather than contracting, tax exemption for governmental retirees. These exemptions have existed for nearly two decades which demonstrates a significant measure of "intensity of commitment to the residual policy" of exemption for



retirement benefits of governmental employees.

Second, the "degree of potential disruption of the statutory scheme" which would occur by withdrawing the tax exemption for those who currently enjoy it would be severe. The exemptions represent a conscious legislative policy conferring a benefit on tens of thousands of government employees. This represents a legitimate and important governmental purpose which would be absolutely frustrated by a judicial decision withdrawing the exemption. In Heckler v Mathews, 465 US 728 (1984), this Court upheld a five-year extension of an invalid gender-based classification used in determining social security spousal benefits primarily because the court recognized the "legitimate and important

governmental purpose" and the hardship which would result to individuals who had planned their retirements in reasonable reliance on the prior law. In <u>Heckler</u> v <u>Mathews</u>, the Court had the benefit of extensive congressional findings which are absent in the instant case because neither the Michigan courts nor the Michigan legislature have yet had an opportunity to consider the consequences of a decision holding the tax exemption system invalid, but it cannot be doubted that the Michigan statutory system conferring tax exemption on the retirement benefits received from many public retirement systems would have a substantial negative impact upon tens of thousands of Michigan taxpayers as well as upon taxpayers in the several states with similar statutory provisions. Much



of the rationale used by the Court in <u>Heckler</u> v <u>Mathews</u> is therefore applicable in the instant case, 465 US at 748:

> "In short, particularly in the years immediately preceding retirement, individuals make spending, savings, and investment decisions based on assumptions regarding the amount of income they expect to receive after they stop working. For such individuals reliance on the law in effect during those years may be critically important."

Just as in <u>Heckler</u> v <u>Mathews</u>, 465 US at 748, extending the tax exemption to a small additional group of federal retirees rather than withdrawing it from a large group of other governmental retirees would protect "people who are already retired, or close to retirement, from public employment and who cannot be expected to readjust their retirement plans to take account of" a sudden dramatic increase in their state tax

liability.

Third, in Califano v Westcott, supra, 443 US at 89-90, this Court recognized,

> "In previous cases involving equal protection challenges to under-inclusive federal benefits statutes this court has suggested that extension, rather than nullification, is the proper course."

While the instant case deals with arguments based on the principle of intergovernmental tax immunity, as well as traditional principles of equal protection, and concerns a state statute conferring tax benefits rather than a federal benefit statute, the situations are somewhat analogous and the same principle should apply. The Court in Califano v Westcott examined equitable considerations including the fact that nullification would have the effect of terminating benefits to many families



currently receiving them, 443 US at 92, and observed that, just as in the instant case, any negative financial consequences caused by extension of benefits would be absorbed by the government rather than the individuals who currently benefit from the exemption, 443 US at 93.

Fourth, Justice Harlan's opinion in Welsh put great importance upon the existence of a severability clause in the statute at issue in determining that the appropriate remedy was extension rather than nullification. Although the existence of a severability statute is not always dispositive, see Dorchy v Kansas, supra, Michigan law contains a severability provision very similar to that in Welsh and Appellees submit that Justice Harlan's rationale is applicable here. Michigan's severability clause provides:

MCL 8.5; MSA 2.216

> "In the construction of the statutes of this state the following rules shall be observed, unless such construction would be inconsistent with the manifest intent of the legislature, that is to say:
>
> "If any portion of an act or the application thereof to any person or circumstances shall be found to be invalid by a court, such invalidity shall not affect the remaining portions or applications of the act which can be given effect without the invalid portion or application, provided such remaining portions are not determined by the court to be inoperable, and to this end acts are declared to be severable."

This is very similar to the severability clause in <u>Welsh</u>, <u>supra</u>, 398 US at 364. Justice Harlan noted the "broad discretion conferred by a severability clause" and then examined the "intensity of commitment to the residual policy" and the "degree of potential disruption of the statutory scheme that would occur by extension as opposed to abrogation", 398



US at 365, and finally concluded that these considerations, when weighed in the context of the statutory policy, compelled the result that the statute should be extended rather than nullified, 398 US at 366:

> "When a policy has roots so deeply embedded in history, there is a compelling reason for a court to hazard the necessary statutory repairs if they can be made within the administrative framework of the statute and without impairing other legislative goals, even though they entail, not simply eliminating an offending section, but rather building upon it." [Footnote omitted]

Similarly in the instant case, the statutory policy of tax exemption for governmental retirement benefits has existed for two decades and more, and the "necessary statutory repairs" can be made "within the administrative framework of the statute and without impairing other legislative goals". The disruption to

the Michigan statutory system caused by extending tax exemption to some additional federal retirees is far less significant than the disruption which would occur by withdrawing the tax exemption for the many retired public employees who currently enjoy the tax exemption.

In summary, if the Michigan tax exemption system is found to be underinclusive in violation of federal law, Appellees submit that the most appropriate remedy would be for this Court to order a refund to Appellant Davis, vacate the judgment of the Michigan Court of Appeals and remand to the Michigan courts with a mandate of equal treatment in order to permit the Michigan courts or the Michigan legislature to determine whether the statutory



exemption should be extended or withdrawn. Alternatively, if this Court chooses to embark upon the determination whether the statutory exemption should be extended or withdrawn, Appellees submit that the exemption should be extended.

## CONCLUSION

The judgment of the Michigan Court of Appeals should be affirmed.

Respectfully submitted,

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(9)

NO. 87-1020



IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

PAUL S. DAVIS,

Appellant

v.

STATE OF MICHIGAN,
DEPARTMENT OF THE TREASURY,

Appellee

ON APPEAL FROM THE
COURT OF APPEALS OF MICHIGAN

# REPLY BRIEF FOR APPELLANT

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OF THE TREASURY, Appellee

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ON APPEAL FROM THE
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---

REPLY BRIEF FOR APPELLANT

In the opinion of the Appellant the issues in this case and the pertinent authorities have been fully set forth in the Briefs filed by Appellant and by the United States and the National Association of Retired Federal Employees ("NARFE"), as *amici curiae*. However it appears appropriate to answer some of the arguments presented by Appellant in its Brief.

1. A RETIRED FEDERAL EMPLOYEE HAS A LEGAL RIGHT, AS AN INDIVIDUAL TAXPAYER, TO ASSERT OBJECTIONS TO A STATE TAX ON THE GROUND OF DISCRIMINATION IN VIOLATION OF 4 U.S.C. 111.

Appellee the State of Michigan in its Brief contends that an individual Federal employee may not assert rights based on discrimination in violation of 4 U.S.C. 111, but that such rights may be asserted only by the Government (Brief, Point I, A, especially pages 11 to 24). Appellee relies on Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939), in which this Court approved State taxation of Federal salaries and overruled prior conflicting cases.

Appellee cites language in the Graves case stating that no showing had been made of any burden on the Government. However, in that case there was no allegation of discrimination. Hence there was no occation for the

Court to consider the rights and remedies of a Government employee who might have been the subject of discrimination. The cases discussed in the Briefs of Appellant and the amici curiae, including particularly Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983), Phillips Chemical Co. v. Dumas Independent School District, 361 U.S. 376 (1960), and Moses Lake Homes, Inc. v. Grant County, 365 U.S. 744 (1961), all show that where discrimination is shown against a party dealing with the Government, that party has in each case been permitted to assert his rights.

Appellee refers to language in the House and Senate Committee Reports on the bill which became the Public Salary Tax Act concerning the prohibition against discrimination (Brief, pages 34 to 37). Appellee cites language concerning the protection of the Federal

Government from threats to its "efficient operaion." But the language of the statute is much broader, since it prohibits <u>any</u> discrimination in the State tax law against the Government officer or employee "because of the source of the pay or compensation," language clearly applicable to the present case.

The Court's opinion in the <u>Graves</u> case, in sustaining the right of a State to tax Federal salaries, emphasized that it was considering a "non-discriminatory" tax on income (306 U.S. 466 at 480, 485). Justice Franfurter's concurring opinion stated that "state and Federal governments must avoid exactions which discriminate against each other" (page 488).

It may be noted that the argument of Solicitor General Jackson for the United States, as summarized in the

official report of the Graves case, expressly refers to the tax in that case as being a "non-discriminatory net income tax" (306 U.S. at 474). The Brief of the United States as filed in that case emphasized that the tax was non-discriminatory, and cited various cases where taxes were sustained as being non-discriminatory (Brief of the United States as Amicus Curiae in the Graves case, October Term, 1938, Case No. 478, pages 99-101). On this point that Brief concluded:

> "The increasing frequency with which the Court has emphasized the nondiscriminatory operation of the taxes indicates that it is a factor of considerable importance." (Brief, page 101).

In view of the foregoing, Appellee's arguments based on the Graves case are inapplicable, since that case involved a non-discriminatory tax. By contrast the present case presents a clear case of discrimination in violation of the

mandate of 4 U.S.C. 111.[*/] Accordingly the Appellant as a Federal retiree is entitled to relief under that statute.

2. APPELLANT IS CLEARLY WITHIN THE SCOPE OF 4 U.S.C. 111.

Appellee in its Brief repeats the reasoning used by the Michigan Court of Appeals, which concluded that Appellant is not within the protection of 4 U.S.C. 111 because he is not a present employee. This argument is discussed in Appellant's main Brief (pages 14 to 18) and in the Briefs of the United States (pages 6 to 7) and of NARFE (pages 5 to 8), which point out that a retiree receives deferred compensation. The NARFE Brief emphasizes the legislative history of the Civil Service Retirement Act.

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*/ Appendix A to this Brief sets forth a chronology of the legislative history of the Public Salary Tax Act (now 4 U.S.C. 111) and of the *Gerhardt* and *Graves* cases in the Supreme Court.

Appellee also argues that the last clause of 4 U.S.C. 111 must be limited to present employees (Brief, page 42). However, the statute must be read as a whole to refer to the compensation "as" an officer or employee, which will include deferred compensation. Accordingly Appellant as a retiree is clearly within the scope of 4 U.S.C. 111.

3. DIFFERENCES IN THE COMPUTATION OF FEDERAL AND STATE RETIREMENT BENEFITS DO NOT JUSTIFY THE DISCRIMINATION AGAINST FEDERAL RETIREES.

Appellee argues that even if there is discrimination in tax treatment of Federal and State retirees, such discrimination is justified by differences between the amounts of Federal and Michigan retirement benefits (Brief of Appellee, pages 49-57). Appellee refers to the Michigan State Employees Retirement Plan as having a "multiplier" percentage for computing the retirement annuity of 1.5%,

as compared with a "sliding scale" multiplier of from 1.5% to 2.5% for Federal retirees (Brief, page 54).

It is submitted that such differences in the annuity computation, and the other differences cited by Appellee in the retirement plans, are irrelevant. The fact of discrimination exists -- Michigan taxes Federal retirement benefits but exempts its own.

As mentioned by Appellee in its Brief (footnote, page 53), Michigan has various retirement plans for different categories of State and local employees. Thus while the State Employees Retirement System uses a multiplier of 1.5% (M.C.L. 38.20), as does the Public School Employees Retirement System (M.C.L. 38.1384), the Michigan Municipal Employees Retirement System uses various multipliers ranging from 1% to 2.5% (M.C.L. 38.1513 to 1522), depending on categories and local options.

The Michigan State Police Retirement System uses a multiplier of 2.4% (M.C.L. 38.1624). The Michigan Judges and Probate Judges Retirement Systems use multipliers of from 2.5% to 3.5% (M.C.L. 38.814 and 916). The Michigan Legislative Retirement System has a multiplier of 4% for the first 16 years, with 1% thereafter up to a maximum benefit of 68% (M.C.L.38.1023).

With such variations in Michigan retirement benefits, it cannot be said that Federal benefits are necessarily more generous, even if such a comparison is relevant.

In addition, the Michigan Income Tax Act gives a complete exemption to public retirement benefits of any other State (and its political subdivisions) if that State gives a reciprocal tax exemption to Michigan retirees (M.C.L. 206.30(1)(h)(ii), set forth in the Jurisdictional

Statement, Appendix F, page A16, and in Appellee's Brief, page xii).

Appellant submits that the discrimination against Federal retirees is not justified, and is in violation of 4 U.S.C. 111.

## CONCLUSION

Appellant submits that the decision of the Michigan Court of Appeals should be reversed. Appellant restates the Conclusion and the prayer for relief set forth in his principal Brief (page 27).

Part II of Appellee's Brief (pages 58 to 83) discusses the appropriate remedies in the event this Court reverses the Court of Appeals and requires equal treatment of Federal and State retirees. Appellant concurs in Appellee's recommendation that in this event the tax exemption be extended to Federal retirees.

Respectfully submitted,

PAUL S. DAVIS
Attorney for Appellant, pro se

November 1988

CHRONOLOGY OF LEGISLATIVE HISTORY OF PUBLIC SALARY TAX ACT AND SOME SIGNIFICANT SUPREME COURT PROCEEDINGS -- 1938-39.

1938

| | |
|---|---|
| Apr. 7-8 | Argument in Helvering v. Gerhardt |
| Apr. 25 | President Roosevelt's Message to Congress |
| May 23 | Decision in Helvering v. Gerhardt, 304 U.S. 405 |
| June 24 | Study by Department of Justice on "Taxation of Government Bondholders and Employees -- The Immunity Rule and the Sixteenth Amendment." |
| Dec. 19 | Certiorari granted in Graves case |

1939

| | |
|---|---|
| Jan. 19 | President Roosevelt's Second Message to Congress |
| Jan. 26 | Hearings before House Ways and Means Committee |
| Feb. 7 | House Committee Report |
| Feb. 9 | House Debate and Passage of Bill (H.R. 3790) |
| Feb. 16 | U.S. Government Brief filed in Graves case |
| Feb. 21 | Senate Finance Committee Hearings |

1939

| | |
|---|---|
| Feb. 24 | Senate Finance Committee Report |
| March 6 | Argument in *Graves* case |
| March 27 | Decision in *Graves* v. *N.Y. ex rel. O'Keefe* 306 U.S. 466 |
| Apr. 3-6 | Senate Debate and Passage of Bill |
| Apr. 12 | Bill signed by President (Public Law 32 -- Public Salary Tax Act of 1939) |

(6)

No. 87-1020

IN THE

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OCTOBER TERM, 1988

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**On Appeal from the Court of Appeals of Michigan**

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**BRIEF *AMICUS CURIAE* OF THE NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES IN SUPPORT OF APPELLANT**

---

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## QUESTION PRESENTED

Whether the State of Michigan, in the application of its income tax laws, may discriminate against federal annuitants and accord them less favorable treatment than that which it affords its state and local government annuitants.

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## BRIEF *AMICUS CURIAE* OF THE NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES IN SUPPORT OF APPELLANT

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The National Association of Retired Federal Employees ("NARFE") submits this brief *amicus curiae* to urge that the Court reverse the decision below and invalidate Michigan's income tax law that discriminates against federal annuitants.

## INTEREST OF NARFE

NARFE is a nonprofit, incorporated association having its principal place of business in Washington, D.C. From its original fourteen charter members, NARFE has

grown to a membership now exceeding half a million federal annuitants (retirees and survivors) living throughout the 50 states, Puerto Rico, the Canal Zone, the Republic of the Philippines, and various foreign countries. NARFE has been a major advocate in maintaining the integrity of the federal government's civilian retirement systems and has been directly involved, through lobbying and related activities, in all legislative and executive changes in these systems over the past six decades.

NARFE has concerned itself with issues affecting the aged and aging, and in particular those issues that affect federal annuitants. NARFE's goal is to identify issues of particular importance to federal annuitants, to inform them, through its Newsletter and the state and local chapter network, of these issues, and to act upon these issues to further the members' common goals. NARFE also assists federal annuitants in obtaining benefits to which they may be entitled under the retirement laws by interacting with various federal agencies and private entities on such matters as federal annuities and health and life insurance benefits.

This case presents questions calling for application of the Supremacy Clause of the Constitution and implicating the doctrine of intergovernmental tax immunity. Under Michigan law, annuities paid by the state, or local governments within the state, are exempt from state income tax. Annuities paid by the federal government are only partially exempted from such taxation and are fully taxed past a certain threshold level. Thus, federal annuitants are accorded less favorable treatment than Michigan state and local government annuitants, and indeed, annuitants of other state and local governments whose states provide a reciprocal exemption for Michigan annuities.

Michigan is not unique among the states in so discriminating against federal annuitants. Several other states, including, for example, Arizona, Arkansas, Georgia, New York and Virginia, similarly accord preferential treatment to annuitants of their own state and local governments.[1] Because this Court's decision will affect federal annuitants in these and other states throughout the country, NARFE has obtained the consent of the parties to participate in this matter as *amicus curiae*.[2]



## ARGUMENT

Michigan's income tax law according preferential treatment to state and local annuitants *vis-a-vis* federal annuitants is invalid under the Supremacy Clause of the Constitution. Foremost, this law is superseded by 4 U.S.C. § 111, which authorizes the states to tax compensation of employees of the United States "if the taxation does not discriminate against the officer or employee because of [its] source . . ." Annuities received by federal retirees are deferred compensation for past services rendered. The Michigan statute, which would grant the exemption to federal annuitants but for the fact of its source, plainly contravenes 4 U.S.C. § 111.

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[1] *See* Ariz. Rev. Stat. Ann. § 43-1022(3), (4) (annuities of retired state employees are wholly exempt from taxation; only the first $2,500 of income from a federal annuity is exempt); Ark. Stat. Ann. § 26-51-307(a), (b) (1987) (retirement benefits of state employees who retire before December 31, 1989 are wholly exempt from taxation; after that date state annuitants will be treated the same as federal annuitants, and may exempt only the first $6,000 of retirement benefits); Ga. Code § 48-7-27(a)(4) (exempting only state employees' annuities and retirement benefits from taxation); N.Y. Tax Law § 612(c)(3) (wholly exempting state employees' pensions from taxation); Va. Code § 58.1-322.C.3 (exempting Commonwealth employees' retirement income from taxation). *Contra* Ala. Code § 40-18-19(a) (exempting from taxation income received from federal and state employees' annuities); Kan. Stat. Ann. § 79-32,117(c) (exempting income received as federal civil service employee annuity).

[2] Counsel for appellant and appellee have consented to the filing of this brief. Their letters have been filed with the Clerk pursuant to Rule 36.2 of the Rules of this Court.

Moreover, Michigan's statute violates the doctrine of intergovernmental tax immunity embodied in the Supremacy Clause. Of course, since this case can be resolved on statutory grounds, this Court need not reach this constitutional issue. Nonetheless, the intergovernmental tax immunity component of the Supremacy Clause prohibits any state from imposing a tax that discriminates against the federal government or those with whom the government deals. Michigan's tax law favors its own annuitants at the expense of federal annuitants. This the Constitution forbids.

**A. Michigan's Discriminatory Tax Violates 4 U.S.C. § 111**

It is, of course, axiomatic that under the Supremacy Clause (Art. VI, Cl. 2) a state measure that conflicts with a federal statute must yield. *McCulloch* v. *Maryland*, 17 U.S. 316, 406 (1819); *Swift & Co.* v. *Wickham*, 382 U.S. 111 (1965). This is so where there is a conflict between federal law and the application of an otherwise valid state enactment, no less than where there is a clear collision between the text of federal and state statutes. *Hamm* v. *City of Rock Hill*, 379 U.S. 306 (1964).

The state law at issue here (Mich. Comp. Laws Ann. § 206.30(1)(h) (West 1986 & Supp. 1988); Mich. Stat. Ann. § 7.557(130) (Callahan 1984)) concededly discriminates against federal retirees and in favor of Michigan state and local governmental retirees. This is expressly accomplished in the state internal revenue code through an "adjustment" to the definition of "taxable income" that excludes completely from state taxation "[r]etirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state." Mich. Stat. Ann. § 7.557(130)(1)(h)(i).

This same benefit is made available on a reciprocal basis for public pensions and the like that derive from other states or their subdivisions. Mich. Stat. Ann.



§ 7.557(130)(1)(h)(ii). However, pensions and retirement benefits received from all other sources, including federal retirement benefits, are deductible only up to $7,500 for a single return and $10,000 for a joint return. Mich. Stat. Ann. § 7.557(130)(1)(h)(iii).

Thus, Michigan's tax law treats federal pensions and retirement benefits less favorably than those that have Michigan state or its subdivisions as their source. This differential treatment plainly runs afoul of 4 U.S.C. § 111, and because this is a federal measure, and therefore supreme, the state enactment must give way.

The Court of Appeals of Michigan reasoned that 4 U.S.C. § 111 was inapposite because "a retired federal civil service employee is not to be considered an employee for civil service purposes." J.S. App. A4-A5. Yet there is nothing in the statute that limits the ban on discrimination solely to those employees who are working at the time of the taxation. The state court's construction to so restrict 4 U.S.C. § 111 is plainly wrong.

On its face, the statute prohibits discrimination in the taxation of "compensation for personal service as an officer or employee of the United States . . . because of the source of the pay or compensation." The statute incorporates no temporal limitation, nor does it impose any requirement that the compensation be paid while the person is actually serving as an employee. This is plain from the face of the statute, and there is no suggestion that a contrary intent was expressed in the enactment's reported history.

Thus, Michigan's discriminatory tax law could only survive 4 U.S.C. § 111 if the retirement benefits at issue here were other than "pay or compensation for personal service as an officer or employee of the United States." Yet Congress intended, and the courts have recognized, that federal civil service retirement benefits are deferred compensation which are earned "for personal service as

an officer or employee of the United States" in the same way that basic pay by federal officers and employees is earned.

That the benefits earned under the federal retirement system were to be treated as compensation was signaled early in the debates surrounding the original Retirement Act of 1920. Representative Hammil, one of the active proponents of the legislation, made the point as follows:

> This pension bill must not be regarded as governmental generosity. Pensions are not gratuities, and they should not be considered as such. They should be looked upon as deferred wages—as payments of wages which were not disbursed at the time when they were earned.

59 Cong. Rec. H6300 (daily ed. April 29, 1920) (statement of Rep. Hammil). In a similar vein, Representative Mann, another of the proponents of the legislation, noted that the benefit received under the retirement legislation "is part and parcel of the subject of the wage you pay." 59 Cong. Rec. H6378 (daily ed. April 30, 1920) (statement of Rep. Mann).

Recognition that federal retirement benefits are merely a deferred form ~~of~~ compensation has persisted from the system's original enactment through the various Congresses that from time-to-time have amended the law. Thus, Representative Withrow in 1952 noted that "we all want to provide relief to the retired employees, not as a gratuity but as a matter of right." 98 Cong. Rec. H8969 (daily ed. July 2, 1952) (statement of Rep. Withrow). Later, in 1958, Representative Cederberg quoted the Director of the Bureau of the Budget: "[t]he Retirement Act promises to make certain payments under specified conditions . . . [and there] are no conditions attached. It is a perfectly open and straight-forward obligation." 104 Cong. Rec. H5825 (daily ed. March 31, 1958) (statement of Rep. Cederberg).



The pertinent statutory provision also confirms that Congress conceived and established retirement benefits as deferred compensation. More specifically, 5 U.S.C. § 8334 (b) provides as follows:

> Each employee or Member is deemed to consent and agree to these deductions from basic pay. Notwithstanding any law or regulation affecting the pay of an employee or member, payment less these deductions is a full and complete discharge and acquittance of all claims and demands for regular services during the period covered by the payment, *except the right to the benefits to which the employee or Member is entitled under this subchapter.*

(Emphasis added).

This language derives from Section 9 of the original Civil Service Retirement Act, enacted May 12, 1920, 41 Stat. 614:

> That every employee coming within the provisions of this Act shall be deemed to consent and agree to the deductions from salary, pay, or compensation as provided in section 8 hereof, and payment less such deductions shall be a full and complete discharge and acquittance of all claims and demands whatsoever for all regular services rendered by such employee during the period covered by such payment, *except the right to the benefits to which he or she shall be entitled under the provisions of this Act . . .*

(Emphasis added.)

The language of Section 9, as that of the successor formulation, is plain. It conveys clearly that the retirement benefits for which an employee qualifies are deferred compensation. Part of an employee's compensation is paid to him or her at the time the service is performed. While part of the salary is withheld as retirement deductions, compensation continues to be paid until the employee ceases to receive retirement benefits.

The Civil Service Retirement Act has been amended many times since its original enactment in 1920. *See, e.g.*, 44 Stat. 904; 47 Stat. 1489; 52 Stat. 943; 56 Stat. 13; 59 Stat. 411; 60 Stat. 939; 62 Stat. 504; 63 Stat. 609; 70 Stat. 532; 74 Stat. 358; 76 Stat. 832; 80 Stat. 288; 83 Stat. 136. At all times and in all versions the Act has contained language that has the same meaning as the original Section 9 and includes the same guarantee of retirement benefits as part of compensation. Thus Congress has consistently recognized federal annuities as part and parcel of the compensation paid to government officers and employees.

On the basis of the foregoing, it cannot be disputed that federal retirement benefits are earned compensation, alike in every respect to basic wages except that retirement compensation is deferred. *See also Kizas* v. *Webster*, 707 F.2d 524, 535-36 (D.C. Cir. 1983), *cert. denied*, 464 U.S. 1042 (1984) (characterizing federal retirement benefits as one of the "incidents of employee compensation"). Accordingly, 4 U.S.C. § 111 is directly implicated. As with the basic wages of federal employees, Congress has mandated that retirement benefits, too, cannot be discriminatorily taxed by state or local jurisdictions. Since this is precisely the practice the Michigan appeals court found to be sanctioned by the state law at issue here, that state law must yield under the well-established principles of federal law supremacy.

### B. Michigan's Discriminatory Tax Violates The Intergovernmental Tax Immunity Doctrine

It is a "fundamental rule of judicial restraint" that before reaching "any constitutional questions, federal courts must consider nonconstitutional grounds for decision." *Jean* v. *Nelson*, 472 U.S. 846, 854 (1985), *quoting Gulf Oil Co.* v. *Bernard*, 452 U.S. 89, 99 (1981) and *Three Affiliated Tribes of the Fort Berthold Reservation* v. *World Engineering*, P.C., 467 U.S. 138, 157 (1984). Indeed, "[i]f there is one doctrine more deeply rooted than any other in the process of constitutional adjudication, it is that [courts] ought not to pass on questions of constitutionality . . . unless such adjudication is unavoidable." *Jean* v. *Nelson*, 472 U.S. at 854, *quoting Spector Motor Service, Inc.* v. *McGaughlin*, 323 U.S. 101, 105 (1944). We submit that this case can be easily resolved on statutory grounds, *i.e.*, that Michigan's preferential tax statute violates the mandate of 4 U.S.C. § 111, and thus this Court need not reach the constitutional issue presented here. Nonetheless, Michigan's tax preference law does violate the intergovernmental tax immunity doctrine of the Supremacy Clause and is invalid on this basis as well.



Although its application has often in the past proven problematic, the basic tenet of the intergovernmental tax immunity doctrine is straightforward: a state may not impose a tax which discriminates against the federal government or "upon those with whom it deals." *Moses Lake Homes, Inc.* v. *Grant County*, 365 U.S. 744, 751 (1961), *quoting United States* v. *City of Detroit*, 355 U.S. 466, 473 (1958). Michigan's tax taps compensation of former employees of the federal government while excluding the identical income from state and local sources. Even if Congress had fashioned federal annuities as other than deferred compensation, plainly federal annuitants are persons "with whom the government deals." Accordingly, there can be no dispute that Michigan's tax infringes this basic component of the Supremacy Clause.

To be sure, Michigan may have a "rational basis" for its differentiation between state and local annuitants and other retirees. But Equal Protection analysis in inapposite where, as here, the State has trespassed the Supremacy Clause of the Constitution. *Phillips Chemical Co.* v. *Dumas Independent School District*, 361 U.S. 376, 385 (1960). Rather, Michigan's discriminatory tax could survive, if at all, only upon demonstration of a significant

and compelling need for the discriminatory treatment. *Id.*, 361 U.S. at 383. Michigan's minimal assertion of a "rational basis" does not satisfy this more exacting standard.

Similarly, Michigan's statute is not saved by the fact that it treats federal annuities equally as poorly as it treats all other non-Michigan annuities. In *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392, 398-99 (1983), this Court rejected the analogous argument that Tennessee's bank tax was nondiscriminatory because it treated federal obligations the same as private ones, according preferential treatment only to obligations of Tennessee and its political subdivisions. *See also Phillips Chemical Co.*, 361 U.S. at 381-82 (noting that the absence of discrimination between the federal government and private parties did not save a statute that imposed lesser tax burdens on lessees of state property). Intergovernmental tax immunity requires a state to treat the federal government, and those with whom it deals, no less favorably than it treats itself. This Michigan plainly has failed to do. Accordingly, its discriminatory tax must be stricken.

## CONCLUSION

For the foregoing reasons, the decision of the court below must be reversed.

Respectfully submitted,

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No. 87-1020

# In the Supreme Court of the United States

OCTOBER TERM, 1988

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PAUL S. DAVIS, APPELLANT

*v.*

STATE OF MICHIGAN

---

*ON APPEAL FROM THE MICHIGAN COURT OF APPEALS*

---

**BRIEF FOR THE UNITED STATES AS AMICUS CURIAE**

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## QUESTION PRESENTED

Whether the doctrine of intergovernmental tax immunity, as embodied in 4 U.S.C. 111, prevents the State of Michigan from taxing the retirement benefits of former federal employees while exempting from taxation retirement benefits paid by the State and its political subdivisions.

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## INTEREST OF THE UNITED STATES

The State of Michigan exempts from taxation all pensions paid to retired employees of the State of Michigan and its political subdivisions. Pensions received from other sources, including the federal government, are taxed when they exceed certain limits. This disparate treatment afforded to state and federal pensions harms the United States in two respects. First, the United States is put at a competitive disadvantage in hiring qualified employees. In order to provide its retirees with the same net after-tax benefit as state retirees—and, hence, in order to attract the same quality of employee—the United States must pay out more money in pension benefits than the State.

Second, through the use of its discriminatory tax scheme, the State is indirectly forcing the United States to subsidize the pensions of state retirees through lower federal tax revenues. If the State taxed its own pension

benefits, and increased pensions to offset that tax, the increase in pensions would in turn increase the federal tax liability of state retirees. Thus, in order to confer the same monetary advantage upon state retirees, the State would have to pay out more in additional benefits than it foregoes in lost tax receipts. At bottom, therefore, the special tax exemption for state retirement benefits amounts to an effort to increase the net after-tax benefit received by retired state employees at the expense of federal taxpayers.

Under the nondiscrimination principle, which is part of the doctrine of intergovernmental tax immunity, the State must make a choice. It can impose a tax on both state and federal pensions (thereby increasing the costs of both the federal and state governments) or it can make both federal and state pensions nontaxable (thereby decreasing the revenues of both federal and state governments). But it cannot impose a tax on federal pensions that does not apply to state pensions; such a tax increases the costs and decreases the revenues of the federal government while simultaneously decreasing the costs and increasing the revenues of the state government.

## STATEMENT

1. The State of Michigan exempts from taxation all pensions and retirement benefits paid to retired employees of the State of Michigan and its political subdivisions. Pensions and retirement benefits received from other sources, including federal retirement benefits, are deductible only up to $7,500 for a single return and $10,000 for a joint return. See Mich. Comp. Laws Ann. § 206.30 (1)(f) (West 1986 & Supp. 1988); Mich. Stat. Ann. § 7.557 (130) (Callaghan 1984).[1]

[1] Section 206.30(1)(f) provides in relevant part:

(1) "Taxable income" in the case of a person other than a corporation, estate, or trust means adjusted gross income as defined in the internal revenue code subject to the following adjustments:

* * * * *

(f) Deduct to the extent included in adjusted gross income:

(i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.

(ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.

(iii) Social security benefits as defined in section 86 of the internal revenue code.

(iv) Retirement or pension benefits from any other retirement or pension system as follows:

(A) For a single return, the sum of not more than $7,500.00.

(B) For a joint return, the sum of not more than $10,000.00.



Appellant is a retired federal employee living in Michigan. After paying state income tax on his federal pension for a number of years, appellant filed a complaint in the Michigan Court of Claims seeking a refund. He alleged that the Michigan Income Tax Act discriminated in favor of state retirement benefits and against federal retirement benefits in violation of 4 U.S.C. 111.[2]

2. On cross-motions for summary judgment, the Michigan Court of Claims concluded in an oral opinion

[2] Section 111 provides in pertinent part:

The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States * * * by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

that the Michigan Income Tax Act did not violate Section 111 because a retired federal civil servant is not currently an "officer or employee of the United States" within the meaning of that provision (J.S. App. A10-A11). The Michigan Court of Appeals affirmed (*id.* at A1-A8). The court agreed with the Court of Claims that someone who is not currently working for hire is not an "employee." Section 111, the court therefore concluded (J.S. App. A6), "has no application to [appellant], since [appellant] cannot be considered an employee within the meaning of that act."

The court of appeals further concluded that the Michigan Income Tax Act did not violate equal protection because the favorable treatment afforded to state retirees "bear[s] a rational relationship to a legitimate state end" (J.S. App. A6-A7). "In our opinion," the court stated (*id.* at A7), "the attracting and retaining of qualified employees is a legitimate state objective which is rationally achieved by a retirement plan offering economic inducements" such as "tax exempt status for their retirement benefits." The court justified the discrimination against similarly-situated federal employees by noting (*ibid.*) that "[t]he State of Michigan, as an employer, owes a special responsibility to its employees, which it does not owe to federal employees." Appellant's application for leave to appeal to the Supreme Court of the State of Michigan was denied (*id.* at A9).

## SUMMARY OF ARGUMENT

Contrary to the Michigan Court of Appeals, Section 111 applies not simply to the taxation of current employees of the United States, but to "the taxation of pay or compensation for personal service as an officer or employee of the United States." Appellant's pension is clearly compen-



sation, albeit deferred compensation, "for" his years of "service as an * * * employee of the United States." Appellant's pension therefore falls within the scope of Section 111.

Section 111 itself merely restates, in the context of state taxation of the compensation of federal employees, the general constitutional rule requiring nondiscrimination in state taxation of those dealing with the federal government. Under the nondiscrimination principle, a State may not treat its own former employees more favorably for income tax purposes than former federal employees, unless there are significant differences that justify treating these two classes of former employees unequally. Neither the lower courts nor appellees have advanced any distinction between state and federal retirees that would qualify under this standard.

Appellant's pension is subject to taxation for the simple reason that it is paid by the federal government rather than by the State or one of its subdivisions. The tax imposed by Michigan on that pension thus discriminates against federal retirees and in favor of state retirees based solely on "the source of the pay or compensation" (4 U.S.C. 111). It follows that the Michigan tax is invalid.

## ARGUMENT

### THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY, AS EMBODIED IN 4 U.S.C. 111, PREVENTS THE STATE OF MICHIGAN FROM TAXING THE RETIREMENT BENEFITS OF FORMER FEDERAL EMPLOYEES WHILE EXEMPTING FROM TAXATION RETIREMENT BENEFITS PAID BY THE STATE AND ITS POLITICAL SUBDIVISIONS

Section 111, by its plain terms, forbids discriminatory taxation of a retired federal employee who, through his pension, is still receiving "compensation for personal serv-

ice as an officer or employee of the United States." If construed the same way as the nondiscrimination principle derived from the doctrine of intergovernmental tax immunity, Section 111 precludes a State from treating its own former employees more favorably for income tax purposes than former federal employees, absent a showing of significant differences between the two classes. Neither the courts below nor appellees have identified any such differences. The judgment of the Michigan Court of Appeals should therefore be reversed.

1. The Michigan Court of Appeals erred in concluding that appellant does not fall within the protection of Section 111. The court stated that as used in other contexts the term "employee" embraces only those who currently work for "hire" and that "a retired federal civil service employee is not to be considered an employee for civil service purposes." J.S. App. A4-A5. That is true (see, *e.g.*, *Chemical Workers* v. *Pittsburgh Glass*, 404 U.S. 157 (1971); *Lancellotti* v. *Office of Personnel Management*, 704 F.2d 91, 95 (3d Cir. 1983)); but it is also irrelevant. By its terms, Section 111 applies not just to the taxation of current employees of the United States, but to "the taxation of pay or compensation for personal service as an officer or employee of the United States." Appellant's pension is clearly compensation, albeit deferred compensation, "for" his years of "service as an * * * employee of the United States." See, *e.g.*, *Zucker* v. *United States*, 758 F.2d 637, 639 (Fed. Cir.), cert. denied, 474 U.S. 842 (1985); *Kizas* v. *Webster*, 707 F.2d 524, 535-536 (D.C. Cir. 1983), cert. denied, 464 U.S. 1042 (1984); *Clark* v. *United States*, 691 F.2d 837, 842 (7th Cir. 1982). Appellant's pension therefore falls within the scope of Section 111.[3] It

[3] Prior to enactment of the Public Salary Tax Act of 1939, ch. 59, 53 Stat. 574, from which Section 111 derives, "pensions or retiring



follows that if the tax imposed by Michigan on that pension discriminates against federal retirees and in favor of state retirees based solely on "the source of the pay or compensation" (4 U.S.C. 111), then the Michigan tax is invalid.

2. Section 111 merely restates, in the context of state taxation of the compensation of federal employees, the general constitutional rule requiring nondiscrimination in state taxation of those dealing with the federal government. That rule, which is part of the constitutional doctrine of intergovernmental tax immunity, arises from the Supremacy Clause (Art. VI, Cl. 2). See *South Carolina* v. *Baker*, No. 94, Orig. (Apr. 20, 1988), slip op. 12, n.10. Under the doctrine of intergovernmental tax immunity, "States may not impose taxes directly on the Federal Government, nor may they impose taxes the legal incidence of which falls on the Federal Government." *United States* v. *County of Fresno*, 429 U.S. 452, 459 (1977). For many years this doctrine was interpreted broadly to prohibit state taxation of the salaries of officers and employees of the United States (*Dobbins* v. *Commissioners of Erie County*, 41 U.S. (16 Pet.) 435 (1842)), as well as federal taxation of the salaries of state officials. *Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1870).[4] In *Helvering* v.

allowances paid by the United States or private persons" were specifically designated as part of the recipient's "[c]ompensation for personal services" under applicable federal tax laws. See, *e.g.*, Treas. Reg. 45, art. 32 (1919); Treas. Reg. 62, art. 32 (1922); Treas. Reg. 74, art. 52 (1929); Treas. Reg. 86, art. 22(a)-2 (1935); Treas. Reg. 101, art. 22(a)-2 (1939). Similarly, state pensions, as "compensation for past services rendered," were specifically excluded from federal taxable income under the doctrine of intergovernmental tax immunity (I.T. 1607, II-1 Cum. Bull. 71 (1923); I.T. 2669, XII-1 Cum. Bull. 68 (1933)), as was other compensation paid by a State or its political subdivisions to its officers and employees (Treas. Reg. 62, art. 88 (1922)).

[4] While federal immunity from state taxation derives from the Supremacy Clause, state immunity from federal taxation is

*Gerhardt,* 304 U.S. 405 (1938), however, this Court implicitly overruled *Day* by permitting the imposition of a federal income tax on employees of the New York Port Authority. One year later, in *Graves* v. *New York ex rel. O'Keefe,* 306 U.S. 466, 480 (1939), the Court expressly overruled *Dobbins,* declaring that "[t]he theory * * * that a tax on income is legally or economically a tax on its source, is no longer tenable." Since *Graves,* "[s]ubsequent cases have consistently reaffirmed the principle that a nondiscriminatory tax collected from private parties contracting with another government is constitutional" (*South Carolina* v. *Baker,* slip op. 15).

Congressional consideration and enactment of the predecessor of Section 111 responded to, and occurred during, the period of judicial abrogation of the *Day-Dobbins* doctrine. Following the Court's decision in *Gerhardt,* Congress believed there was no longer any constitutional impediment to federal taxation of the income of state employees. In view of this development, Congress concluded that, in fairness, federal officers and employees should no longer remain immune from nondiscriminatory state taxation. Section 4 of the Public Salary Tax Act of 1939 (1939 Tax Act), ch. 59, 53 Stat. 575, the predecessor of Section 111, was designed to waive federal immunity to permit such taxation. See H.R. Rep. 26, 76th Cong., 1st Sess. (1939); S. Rep. 112, 76th Cong., 1st Sess. (1939).

grounded in the Tenth Amendment and in principles of federalism derived generally from the Constitution. *South Carolina* v. *Baker,* slip op. 4 n.4. Despite the different sources of the two doctrines, "[c]ases concerning the tax immunity of income derived from state contracts freely cited principles established in federal tax immunity cases, and vice versa" (*id.* at 11). The two docrines are not, however, coterminous. See n.9, *infra.*



Shortly before the 1939 Tax Act was approved by Congress, however, this Court decided *Graves.* Accordingly, the government's "consent[ ] to the taxation of pay or compensation for personal service as an officer or employee of the United States" in Section 111 was, in effect, merely a codification of the intervening decision overruling *Dobbins.* Nonetheless, in conditioning state taxation of federal employees' compensation on the State's "not discriminat[ing] against the officer or employee because of the source of the pay or compensation," Congress anticipated and also codified "[t]he nondiscrimination principle at the heart of modern intergovernmental tax immunity caselaw." *South Carolina* v. *Baker,* slip op. 19 n.14.[5]

3. This Court's decisions construing the nondiscrimination principle in the context of intergovernmental tax immunities indicate that the Michigan Income Tax Act impermissibly "discriminates" against federal retirees within the meaning of 4 U.S.C. 111. Under the nondiscrimination principle, a tax is invalid, even if it is not imposed directly on the United States, " 'if it operates so as to discriminate against the Government or those with whom it deals.' " *Moses Lake Homes, Inc.* v. *Grant County,* 365 U.S. 744, 751 (1961) (quoting *United States* v. *City of*

[5] Congress may by legislation expand federal tax immunity beyond the confines of the constitutional doctrine. See *Baker,* slip op. 12, n.10 ("The Federal Government * * * possesses the power to enact statutes immunizing those with whom it deals from state taxation even if intergovernmental tax immunity doctrine would not otherwise confer an immunity."). Plainly, Section 111 was not designed to extend federal tax immunity. Nor, on the other hand, is there anything in the language or history of Section 111 to suggest that Congress intended further to limit federal tax immunity by drawing a new distinction between working federal employees and federal retirees when it authorized nondiscriminatory taxation. See n.3 *supra.*

*Detroit*, 355 U.S. 466, 473 (1958)). See *South Carolina* v. *Baker*, slip op. 16-17; *Phillips Chemical Co.* v. *Dumas Independent School Dist.*, 361 U.S. 376, 387 (1960). Clearly, the burden of the tax in question here falls on those with whom the United States deals. Appellant's pension is subject to taxation solely because it is paid by the federal government rather than by the State or one of its subdivisions. There can, therefore, be little doubt that the Michigan Income Tax Act operates in a discriminatory fashion in imposing a tax upon the retirement benefits of a former federal employee but not imposing it in similar circumstances upon the retirement benefits of former state employees. The principle of nondiscrimination precludes a State from imposing a tax on federal retirees if "it treats someone else better than it treats them." *Washington* v. *United States*, 460 U.S. 536, 545 (1983).

a. Appellees stress (Mot. to Dis. or Aff. 4) that federal retirees have not been singled out for a tax imposed on them alone. Rather, all pensions that are not paid by the State or one of its political subdivisions are treated alike. This Court's decisions, however, have rejected the notion that a State that treats those who deal with itself more favorably than those who deal with the federal government may avoid the charge of discriminatory taxation simply by treating those who deal with the federal government the same as those who deal with private entities.

In *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392 (1983), Tennessee imposed a tax on the net earnings of banks doing business within the State and defined net earnings to include income from obligations of the United States and its instrumentalities but to exclude interest earned on the obligations of Tennessee and its political subdivisions. Although Tennessee treated income from obligations of the United States the same as income from private obligations, the tax was nonetheless declared in-



valid. "It is clear," the Court noted (*id.* at 398-399 (footnote omitted)), "that under the principles established in our previous cases, the Tennessee bank tax cannot be characterized as nondiscriminatory * * *. Tennessee discriminates in favor of securities issued by Tennessee and its political subdivisions and against federal obligations. The State does so by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals." [6]

Similarly, in *Phillips Chemical Co.* v. *Dumas Independent School Dist.*, *supra*, the State of Texas imposed a lesser tax burden on lessees of state property than it imposed on lessees of federal property. The Court held that the discriminatory tax was invalid despite the fact that "there appears to be no discrimination between the [federal] Government's lessees and lessees of private property" (361 U.S. at 381). The crucial point, the Court noted (*id.* at 382), was that the federal lessee "would not be taxed at all if its lessor were the State or one of its political subdivisions instead of the Federal Government. The discrim-

[6] The Michigan court of appeals (J.S. App. A7-A8) sought to distinguish *Memphis Bank* on the grounds that Tennessee's tax was rendered invalid by a specific federal statute, 31 U.S.C. (1976 ed.) 742, which prohibits all but nondiscriminatory franchise or non-property taxes on federal obligations. See also Mot. to Dis. or Aff. 14-18. Section 111, however, has no less force than Section 742 in forbidding discriminatory taxation. Furthermore, in analyzing Section 742, the Court stated that it viewed that statute "as principally a restatement of the constitutional rule" (459 U.S. at 397) and proceeded to scrutinize the Tennessee tax under the general doctrine of intergovernmental tax immunity (*id.* at 397-398), a doctrine that is equally applicable here. *Memphis Bank* is therefore directly on point.

ination against the United States and its lessee seems apparent." "[I]t does not seem too much," the Court concluded (*id.* at 385), "to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself." [7]

The principles governing *Memphis Bank* and *Phillips Chemical Co.* apply with equal force here. The State of Michigan is discriminating in favor of pensions granted by the State and its political subdivisions and against federal pensions. "The State does so by including in the tax base income from federal [pensions] while excluding income from otherwise comparable state and local [pensions]" (*Memphis Bank,* 459 U.S. at 398 (footnote omitted)). Federal pensioners "would not be taxed at all if [their former employer] were the State or one of its political subdivisions instead of the Federal Government. The discrimination against the United States and its [retirees] seems apparent." *Phillips Chemical Co.,* 361 U.S. at 382. It follows that the Michigan tax "impermissibly discriminates against the Federal Government and those with whom it deals" (*Memphis Bank,* 459 U.S. at 399).

[7] Most recently, in *United States* v. *City of Manassas, Va.*, 830 F.2d 530, 534 (4th Cir. 1987), aff'd, No. 87-1117 (Apr. 25, 1988), the Court affirmed a judgment striking down a Virginia tax statute which provided that a company that leased or borrowed personal property from a governmental body was liable for local taxation as if it were the owner of the property. The statute expressly exempted from its provisions property owned by the Virginia Port Authority or by certain local transportation districts. Under the statute, therefore, "all users of property [were] taxed alike, with the exception of those who use[d] the property of the Virginia Port Authority and local transportation districts, both of which are subdivisions of the government of the Commonwealth" (830 F.2d at 533). The court of appeals held the statute unconstitutional, noting that "the discrimination against the federal government in favor of subdivisions of the state government is obvious" (*ibid.*). This Court affirmed summarily.



b. The Michigan Court of Appeals, without denying that the Michigan Income Tax Act discriminates against former federal employees, sought to justify that discrimination under traditional equal protection principles on the ground that the statutory classification "bear[s] a rational relationship to [the] legitimate state end * * * [of] attracting and retaining * * * qualified employees" (J.S. App. A6-A7). But this Court has already made it clear that ordinary equal protection principles "are not necessarily controlling where problems of intergovernmental tax immunity are involved" (*Phillips Chemical Co.*, 361 U.S. at 385). General policy considerations are not sufficient to justify discriminatory taxation against those who deal with the federal government. "The imposition of a heavier tax burden on [those who deal with the federal government] than is imposed on [those who deal with the State government] must be justified by significant differences between the two classes" (*id.* at 383). The court of appeals made no attempt to justify the differential treatment of state and federal retirees under this exacting standard.

The fact that the discrimination at issue here gives the State a competitive edge does not distinguish it from any special tax benefit given to those who deal with the State rather than the federal government. In *Phillips Chemical Co.*, 361 U.S. at 384, the Court expressly rejected a similar justification proffered by the State that favorable tax treatment for its lessees would "facilitate the leasing of its own land." See also *United States* v. *City of Manassas, Va.*, 830 F.2d at 534 (the only "justification" that would support a statute discriminating against those who deal with the United States is "a showing that the two classes of users, from federal and state sources, are not similarly situated, so that in essence there is no discrimination").

Nor can the exemption of state pension benefits from state taxation be justified on the ground that the State

could accomplish the same result by increasing the amount of benefits paid to retirees. If the State increased pension benefits, this in turn would increase the federal tax liability of state retirees. Thus, in order to confer the same monetary advantage upon state retirees, the State would have to pay out more in additional benefits than it foregoes in lost tax receipts. At bottom, therefore, the special tax exemption for state retirement benefits amounts to an effort to increase the net after-tax benefit received by retired state employees at the expense of federal taxpayers.[8] In *Phillips Chemical Co.*, the Court rejected the contention that differential treatment of lessees of state property could be justified because "the State can collect in rent what it loses in taxes from its own lessees" (361 U.S. at 384); the same argument with respect to state pension benefits and taxes should be rejected here as well.

Federal and state retirees appear to be identically situated for purposes of the tax in question here. So too do the federal and state governments in their capacities as employers. At any rate, neither appellees nor the Michigan Court of Appeals has identified any differences that would justify the disparity in treatment between state and federal pensions. "It follows that [the state tax law,] as applied in this case, discriminates unconstitutionally against the United States and its [retirees]." *Phillips Chemical Co.*, 361 U.S. at 387.

4. The policy considerations underlying the doctrine of intergovernmental tax immunity require that the non-

[8] The differential impact in terms of federal taxation is reduced to some extent by the fact that an increase in pension benefits would yield not only higher federal taxes but also higher state taxes, which are generally deductible from income for purposes of determining federal tax liability. But because state income tax rates are invariably lower than federal income tax rates, the higher deduction would never completely offset the additional federal tax liability.



discrimination principle be interpreted so that whatever tax burden is imposed by a State on those who deal with the United States is imposed equally on those who deal with that State. This parity is necessary because the United States has no representation in the individual States, and one State must not be permitted to pursue its own parochial interests at the expense of the other 49 States. "[W]hen a state taxes the operations of the government of the United States, it acts upon institutions created, not by their own constituents, but by people over whom they claim no control. It acts upon the measures of a government created by others as well as themselves, for the benefits of others in common with themselves." *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316, 435 (1819). Such taxation is subject to abuse because "the people outside the state have no representatives who participate in the legislation; and in a real sense, as to them, the taxation is without representation." *Helvering* v. *Gerhardt*, 304 U.S. at 412.[9]

[9] The same concerns are not present when the federal government levies taxes on those who deal with the States and their instrumentalities. "[I]n laying a federal tax on state instrumentalities the people of the states, acting through their representatives, are laying a tax on their own institutions and consequently are subject to political restraints which can be counted on to prevent abuse. * * * The exercise of the national taxing power is thus subject to a safeguard which does not operate when a state undertakes to tax a national instrumentality." *Helvering* v. *Gerhardt*, 304 U.S. at 412. Accordingly, "[m]any of this Court's opinions have suggested that the Constitution should be interpreted to confer a greater tax immunity on the Federal Government than on States because all the people of the States are represented in the Federal Government whereas all the people of the Federal Government are not represented in individual States." *South Carolina* v. *Baker*, slip op. 12 n.10. It is unnecessary to consider in this case whether the federal government would be precluded from bestowing a tax benefit on federal retirees that was not also granted to state retirees. But it is worth noting simply that "the two cases are not

These concerns, however, are alleviated when the state tax is nondiscriminatory. For when a State taxes those who deal with its own institutions to the same extent as those who deal with federal institutions, the State cannot harm the federal government without inflicting an equal harm upon its own operations. Thus, although "the political check against abuse of the power to tax a State's constituents is absent when the State taxes only a federal function" (*United States* v. *County of Fresno,* 429 U.S. at 458), "[a]s long as the tax imposed on those who deal with the Federal Government is an integral part of a tax system that applies to the entire State, there is little chance that the State will take advantage of the Federal Government by increasing the tax." *Washington* v. *United States,* 460 U.S. at 546.[10]

One might argue that the tax in question here, since it applies to retirees of private employers as well as to federal retirees, "affect[s] enough voters in the State to provide the type of political safeguard envisioned in *M'Culloch* and thereby protect federal employees from the risk of disparate treatment." *County of Fresno,* 429 U.S. at 468 (Stevens, J., dissenting). But this Court's decisions do not

on the same reason." *McCulloch* v. *Maryland,* 17 U.S.C. (4 Wheat.) at 435-436.

[10] The Senate Report that accompanied the predecessor of 4 U.S.C. 111 made clear that, for precisely this reason, any tax a State imposes on federal employees must also be imposed on state employes. S. Rep. 112, 76th Cong., 1st Sess. 9 (1939):

> It should be kept in mind that the proposal before us provides only for nondiscriminatory taxation of the compensation of public employees and is reciprocal in nature. Thus, whatever burden might be passed on to one government because of the taxation of its employees' compensation by another governmental unit would, in a measure at least, be offset by the converse application of the proposal.



suggest that a case-by-case inquiry into "virtual representation" is required once it has been shown that a State is treating those with whom it deals more favorably than those who deal with the federal government. Such an approach would in all likelihood prove to be judicially unmanageable, and would only foster "inconsistent decisions and excessively delicate distinctions" (*United States* v. *New Mexico,* 455 U.S. at 730). Instead, once it has been shown that a State's system of taxation, viewed as a whole, treats the State or those with whom it deals more favorably than the federal government and those with whom it deals, this Court's decisions indicate that discrimination will be presumed. See, *e.g., Memphis Bank & Trust Co.* v. *Garner, supra; Moses Lake Homes, Inc.* v. *Grant County, supra; Phillips Chemical Co.* v. *Dumas Independent School Distr., supra.* Such a rule is not only administratively convenient, it also serves to protect the important policy concerns underlying the doctrine of intergovernmental tax immunity. See *Washington* v. *United States,* 460 U.S. at 546 ("As long as the tax imposed on those who deal with the Federal Government is an integral part of a tax system that applies to the entire State, there is little chance that the State will take advantage of the Federal Government by increasing the tax."); *South Carolina* v. *Baker,* slip op. 19 n. 13 ("the best safeguard against excessive taxation (and the most judicially manageable) is the requirement that the government tax in a nondiscriminatory fashion").[11]

[11] In any event, even if a case-by-case examination of whether the federal government's interests would be adequately represented in the state political process were thought to be appropriate, it is far from clear that private employers operating in Michigan would effectively

Thus, only if the State treats those who deal with the federal government in the same way that it treats those who deal with the State and its political subdivisions can the proper balance of interests sought by the doctrine of intergovernmental immunity be assured. Simply put, the State must make a choice: it can impose a tax on both federal and state pensions (thereby increasing the costs of both the federal and state governments) or it can make both federal and state pensions nontaxable (thereby decreasing the revenues of both federal and state governments). But it cannot impose a tax on federal pensions that does not apply to state pensions, a tax that increases the costs and decreases the revenues of the federal government

represent the interests of the United States. First, private employers, unlike the United States, are subject to corporate and other taxes in the State. Revenues that the State obtains by taxing the pensions of all non-state employees may be reflected in lower corporation or other taxes. Thus, the overall tax structure may well induce private employers operating in the State to favor higher taxes on pensions—where the costs are shared by the federal government—to higher taxes elsewhere that are not shared by the federal government. Second, the United States itself imposes a tax on pensions—both state and federal. See 26 U.S.C. 61(a)(11), 457. Thus, the United States, in addition to paying higher pensions to counterbalance the state tax, will enjoy lower revenues because state pensions, reflecting the fact that they are not taxed by the State, will be lower. See p.14 and n.8, *supra*. Since private employers obviously do not tax state pensions, their interests on this question will again diverge from those of the United States, making effective representation of the interests of the United States doubtful. Obviously, the question whether private employers would provide effective representation of the interests of the federal government here cannot be calibrated with precision; but this simply underscores the wisdom of *presuming* discrimination whenever the State treats those with whom it deals more favorably than those who deal with the federal government.



while simultaneously decreasing the costs and increasing the revenues of the state government. The doctrine of intergovernmental tax immunity was designed to prevent precisely this sort of parochially-motivated disparity in treatment; "it does not seem too much to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself." *Phillips Chemical Co.*, 361 U.S. at 385.[12]

"Although the scope of the Federal Government's constitutional tax immunity has been interpreted more narrowly in recent years, there has been no departure from the principle that state taxes are constitutionally invalid if they discriminate against the Government." *Memphis Bank*, 459 U.S. at 397 n.7. In this "much litigated and often confused field" (*United States* v. *City of Detroit*, 355 U.S. at 473), we know of no case in which the Court has countenanced "so substantial and transparent a discrimination" (*Phillips Chemical Co.*, 361 U.S. at 387) in favor of those who deal with the State and against those who deal with the federal government. "[I]t still remains true,

[12] For purposes of future taxation, the State could respond in a number of ways to a judgment invalidating the differential treatment of former state and federal employees, including eliminating the special exemption for former employees of the State and its political subdivisions, as well as extending this exemption to former federal employees. As in cases claiming a denial of equal protection, the appropriate *prospective* remedy here "is a *mandate* of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class." *Heckler* v. *Mathews*, 465 U.S. 728, 740 (1984) (emphasis in original). With respect to past taxes, however, the State's only option appears to be to give appellant a refund of any taxes he has paid on his federal pension. This Court has twice stated simply that "a discriminatory tax is void and 'may not be exacted.'" *Moses Lake Homes* v. *Grant County*, 365 U.S. at 752 (quoting *Phillips Chemical Co.*, 361 U.S. at 387).

as it has from the time of *M'Culloch* v. *Maryland,* 4 Wheat. 316, that a state tax may not discriminate against the Government or those with whom it deals." *Phillips Chemical Co.,* 361 U.S. at 387.

## CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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